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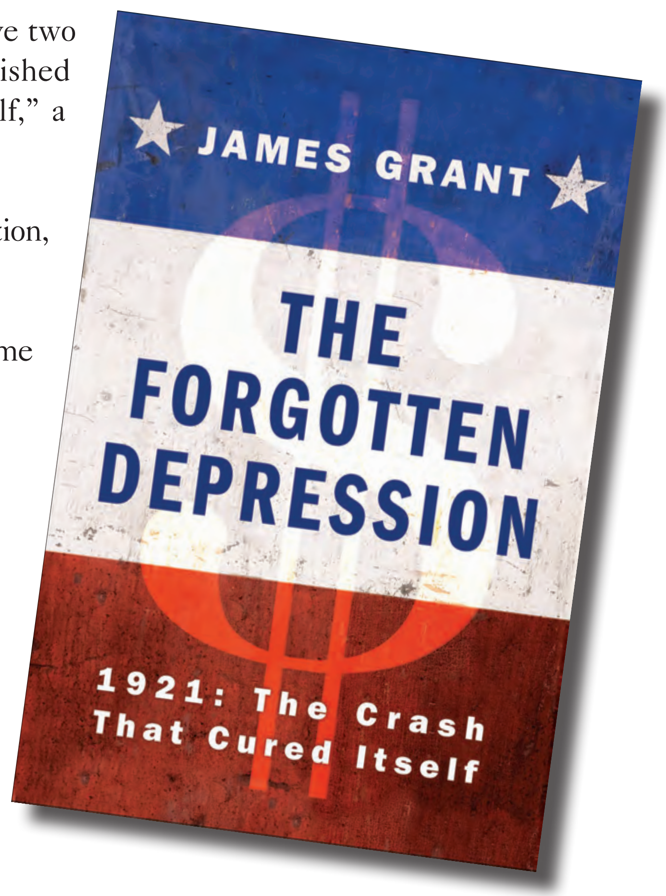


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Let me close by saying how great a privilege it would be to welcome you into the ***Grant’s*** fold!

James Grant,
Editor,
*Grant’s Interest Rate Observer*

# GRANT'S

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# A "thrift" for our time

(May 13, 1988) Countless man-years have been devoted to the search for the perfect investment. It has almost become a banal occupation. However, the hunt for the least perfect investment has attracted relatively little interest. Where is this grail-in-reverse? What would it look like if one came across it?

The worst investment would be badly secured and illiquid, of course. It would offer a yield—but, ultimately, would fail to pay it. It would look substantial but would furnish no substance.

It would be presumptuous to hold up the one-year 9 1/2% debentures or the two-year 10 1/2% debentures of American Continental Corp. as *the* worst securities available. That is up to the financial jury, which is out. At the least, however, the bonds are instructive, for they lead the student of markets to their issuer, American Continental, and then to the issuer's thrift subsidiary, Lincoln Savings & Loan. These are emblematic institutions— companies for our debt-laden, shot- taking time.

You probably have read about Lincoln, a $4.7 billion California thrift that has been fighting with the Federal Home Loan Bank Board. Lincoln is said to have undergone the longest audit in the Bank Board's history, and matters raised in the FHLBB examination report have prompted an order of investigation by the SEC. Charles H. Keating Jr., chairman of American Continental, the holding company, is noted for financial innovation, strong views and survivability. At Lincoln, he chose to make money with credit risk rather than with interest-rate risk, and he transformed a conventional thrift into a space age model. In high places, he counts friends and enemies alike. The *National Thrift News* has disclosed that no fewer than five U.S. Senators intervened with federal regulators last spring on behalf of Lincoln, "pressing for more liberal appraisals on the thrift's real estate investments." In Phoenix, according to a local businessman, Keating has shown "incredible ability to convert assets into cash." He is going to need it (there's talk of a sale of Lincoln itself to a group led by the thrift's newly resigned chairman, but so far no action).

Lincoln is a thrift only in name.

Instead of conventional home mortgages, it has stocked up on commercial real estate, real-estate loans and junk bonds. These assets it finances with federally insured deposits, thereby sharing its risk (but not its profits or the handsome salaries of its officers or the handy privileges of its insiders) with the insurance-assessment-paying members of the thrift industry. Ultimately, if the federal deposit insurance system keeps going downhill, Lincoln will share its risk with the taxpayers, who have not been consulted on the composition of its investment portfolio.

The margin for error is tight. For instance, the real-estate assets of the holding company totaled $821 million at year-end. Of this total, "land acquired for development" was $591 million, "land held for resale" was $170 million and real-estate acquired through foreclosure was $78 million. Allowance for possible losses was $19 million. It is a number that, although double the 1986 reserve, suggests an optimistic reading of the Southwest market (the company's real-estate activities are concentrated in the non- boom states of Arizona, Colorado, Georgia and Texas). To put the $821 million real -estate portfolio in perspective, consolidated year-end equity was $137 million. The junk- bond portfolio is a little smaller than the land portfolio: $622 million at year-end, up from $561 million in 1986, but a large multiple of net worth.

One consequence of the company's emphasis on real-estate investment, or speculation, is that its selling, general and administrative expenses handily exceed its net interest income. Unlike the typical thrift, its income is dependent on the sale of securities and real estate, i.e., on sources of revenue usually deemed irregular, or nonrecurring. American Continental is a kind of real -estate-development and junk-bond enterprise, subsidized, in good measure, by the Federal Savings & Loan Insurance Corp., which is broke.

Since 1984, the year American Continental acquired Lincoln, the holding company's leverage has risen and its return on assets has fallen. Ratio of equity to assets over the past several years has trended this way: 6.36%, 1984; 3.47%, 1985; 2.88%, 1986; and 2.75%, 1987. In 1984, return on average assets was

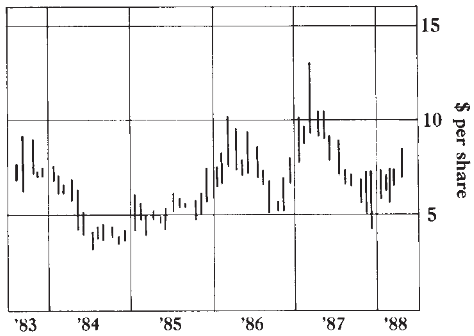
*(Continued on page 2)*

*(Continued from page 1)*

1.02%; in 1987, it was 0.4%. With all that leverage, you might have expected big gains in return on equity, but they didn't happen. ROE was 14.6% last year, a shade lower than in 1984.

With the approval of the Bank Board, American Continental has begun to offer its debentures—the subordinated one- and two-year securities nominated above for consideration as worst investments—in Lincoln's 29 branch offices in Southern California. A five-year bond is also available at 12%. The bonds are meant to be held to maturity or to the holder's death, whichever comes first. The selling literature serves fair warning on the lack of liquidity: "These bonds are not traded in the secondary market, but they can be transferred to another individual. It is the responsibility of the debenture holder to determine a suitable price and locate the buyer." That may or may not be easy, as the field of potential investors, possibly, is limited to people who don't read, or who can't understand, the American Continental prospectus.

**American Continental**




source: M.C. Horsey & Co.

The document is a pip, describing a perfect miniature of new -era finance. For instance: "Virtually all loans made since the acquisition of Lincoln Savings require 'balloon' payments of principal at various points up to, and including, final maturity of the loan.... The risk of loss on all loans depends upon the accuracy of appraisals. However, the risk of loss from an inadequate appraisal for any particular loan is greater with larger loans...." And so forth. The document cautions that debenture holders have no claim against American Continental's subsidiaries, notably the thrift subsidiary. In point of fact, as an interested reader points out, the holding company, ex-Lincoln, suffers a deep negative net worth. How, then, can the bondholders expect to get paid? Absent dividends from subsidiaries (the payment of which depends on approval from Lincoln's friends at the Bank Board), the company means to borrow the money—or tap the subs for miscellaneous advances and "tax sharing agreements."

Some months back, Roderick MacIver & Co., Basking Ridge, N.J., issued a blistering report on American Continental, citing, among other unflattering things, a series of property transactions with insiders. "Over the last three years," said MacIver, "the company has sold $92 million of its properties to entities affiliated with insiders. In one instance, the company provided $3 million in secondary financing to the purchasers, who put none of their own money down."

The 1988 proxy statement disclosed the purchase of 417,000 shares of American Continental stock from the insiders, including 117,000 shares from Keating himself on November 5 at 6. It was a timely accommodation for Keating, inasmuch as the total volume of American Continental traded on NASDAQ that day was just 16,300 shares. It can be imagined that a block of 117,000 shares would have weighed heavily in the marketplace just three weeks after the crash.

The public should be reminded that no such instant liquidity is available to the holders of the American Continental debentures. You must wait out the maturity date or die. The prospectus contains the details. Read it carefully before you invest or send money.

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## *Nikkei put warrants*

(July 7, 1989) The wonderful Herbert Stein remark about patience—"If something can't go on forever, it won't"—has been as good a motto as any to lose money by in this epic bull market. In general, things that can't go on forever have kept right on going. Donald Trump, "trophy" hotel prices, leveraged cable-TV companies, Wasserstein Perella & Co. and the Japanese stock market all come annoyingly to mind.

However, the inevitable can happen, even in the roaring '80s—the break in Integrated Resources is proof—and the Japanese market may yet have its well-deserved comeuppance. If so, you will want to be prepared. Ahead of time, you will want to investigate a little-known series of put warrants on the Nikkei Stock Average. The warrants were issued by Salomon Brothers International. They are relatively liquid (an advantage over the so-called European-style puts issued by some New York brokerage firms) and offer impressive leverage if worse should ever come to worse. By the way, Salomon has also issued a number of Nikkei call warrants. We report this fact for the sake of journalistic balance.

One potential legal obstacle: The warrants were not registered with the Securities and Exchange Commission, and a prospectus states flatly that they "may not be offered, sold or delivered directly or indirectly in the United States . . . or to United States persons." This language may not be the last word, though. Warrants were issued as long ago as June 1988, and your lawyer may opine that they are "seasoned" and

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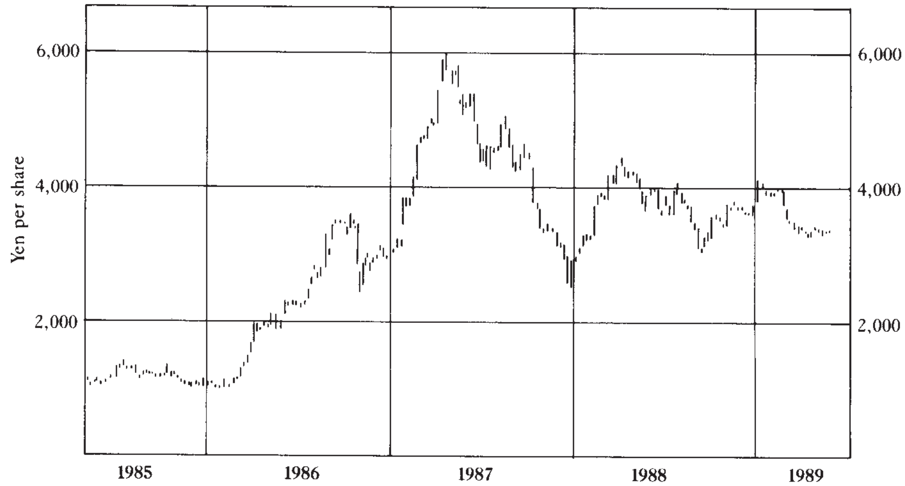
eligible for purchase by a United States person like you. For any American so bearish on the Nikkei that he or she is contemplating a change in citizenship to accommodate a leveraged investment program, the most desirable destination would seem to be Luxembourg. Some of the warrants are listed on the Luxembourg Stock Exchange.

Every faithful reader of *Grant's* can recite the basic bearish case for Japanese stocks in his sleep. The arguments are familiar, even shopworn, but they may yet carry the day. We note, for instance, that our advance-decline line recently made a new low (see page 10)—a mirror to the fact that, whereas the Nikkei 225 -stock average has been going up, many individual stocks have been going down. Then, too, the Japanese political establishment is losing its grip on events, and the Ministry of Finance has made it harder for the big four brokerage firms to manipulate stocks (no one firm is allowed to generate more than 30% of the, trading volume in any one stock on any one day). The accompanying graph of No Securities is suggestive of a chill in the speculative climate. Note that the price peaked in April 1987. And Japanese interest rates have turned higher—in late June, the prime vaulted to 4 1/2% from 4 1/4%. A short, sad item from *The Japan Economic Journal* caught the spirit of the times:

> The option of allowing foreigners to hold shares of Nippon Telegraph and Telephone should be examined when considering Japan's communications policy and NTT's future, Prime Minister Sousuke Uno said June 9 at the Lower House plenary session. Foreigners have not been allowed to buy the share. However, since it has fallen to a low level, the government might possibly allow foreigners to buy the share.

**Nomura Securities—a peak years ago**



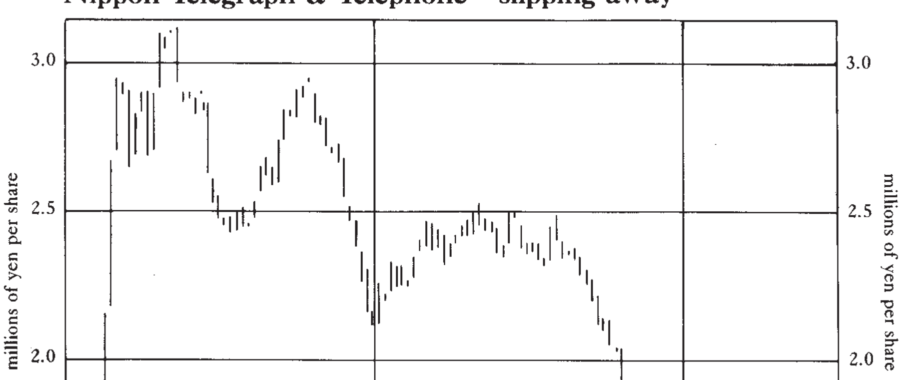

source: Toshi Radar Co. Ltd., *Weekly Data Graphic*

Alternatively, foreigners may choose to buy the Salomon. Let's look at the 28,000 strike-price series. It's the oldest of the three—issued on June 22, 1988, to expire on June 19, 1991—and has, naturally, the lowest strike price. We say "naturally" because the Nikkei does tend to go up, demoralizing the bears and taking their money. The offering price of this first Salomon issue was 28 1/4. It was quoted the other day—some 5,000 Nikkei points higher—at 4 1/2. It is the put-holders' conviction that the bullish spell will break within the next two years.

The arithmetic of the speculation is easy. Break-even is 28,000 (actually, 28,139) on the Nikkei average on the 1991 expiration day. Let's say that that expiration day finds the Nikkei average at 14,000. That is a big assumption, but it is perhaps no more unreasonable than 33,000, the current level. What would the warrants be worth? Just subtract 14,000 from the strike price, 28,000. Result: 14,000. Divide by the exchange rate—let's take 140. Result: 100. That happens to be the price—*in dollars*—of each warrant. So if the Nikkei were to plunge to 14,000, one's $4.50 investment would produce $100. That is without considering any time value that the warrant might have.

The other two Salomon warrants have somewhat higher strike prices. They are the 31,000 series (expiring Aug. 7, 1990) and the 33,000 series (expiring April 24, 1992). As you will see if you work through the arithmetic, however, neither offers as gaudy a return if the bottom falls out. Let's examine the same hypothetical case with the 33,000 series. The strike price minus a 14,000 Nikkei average would yield a price per warrant of about $136. That is a nice-sounding price except in comparison with the current price of the warrant—about $14.20. A collapse to 14,000 would therefore fetch a return of 9.6 times one's money. In the case of the 28,000 series, the leverage would be on the order of 22 times one's money.

**Nippon Telegraph & Telephone—slipping away**




source: Toshi Radar Co. Ltd, *Weekly Data Graphic*

William Fleckenstein, a Seattle money manager (and paid-up subscriber to *Grant's*, by the way), says that, after thoroughly checking the field, he bought the 28,000 series. "I give up the first 9%," he says, comparing them to the 33,000 models, but when [the Nikkei] starts rolling on the down side, I have almost three times as much leverage." The question is: "What is your premise going in?" Fleckenstein goes on. "The idea either works—and the market trades on reality—or they keep it going forever," he says. Thus, he contends that the extra year of time value isn't worth the cost. Yes, we said, but we could just have easily have been bearish in 1988, 1987 or 1986. In fact, we were. Yes, Fleckenstein replied, but the Japanese market is palpably closer to a fall than it was three years ago. Courage, he advised.

Sid Klein, a broker at Prudential-Bache Securities in Montreal, shares Fleckenstein's enthusiasm for the short side of the Japanese market and for the Salomon warrants. His preference, too, is the 28,000 strike series. Put two-thirds or three-quarters of your dry powder in those warrants and the balance in the 31,000 series. His least favorite put vehicle is a series of warrants issued last winter by Bankers Trust's Canadian subsidiary. The leverage inherent in the BT Canada series (which offers a 32,000 strike) on the same hypothetical break in the Nikkei would be less than five times the amount of one's initial investment. So far out of whack is the Canadian series, one might surmise, that some person or persons have been selling it short and buying the 33,000 Salomon series to lock in an arbitrage profit. In any case, Klein continues, the 33,000 series is not as appealing as the other two Salomon issues.

Not that any of this is risk-free. For one thing, the warrants constitute a general, unsecured obligation of Salomon Brothers. They are no better (and no worse) than the creditworthiness of the eminent bond-trading, merchant-banking institution. For another thing, Nikon Keizai Shimbun, which publishes the Nikkei index, might cease to publish it. It might publish a new, or modified index, calling it the son of Nikkei. In that case, Salomon, "in its sole discretion," might choose to adopt this successor index as the real McCoy. Thinking too long about such contingencies, one might never get out of bed in the morning. Or call one's broker.

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## *The slowest asset*

(April 24, 1992) In Houston, office rents are falling again, fully a decade after the Texas energy business stopped inflating and began deflating. Rents continue to fall in New York, too, and Citibank is reportedly trying to sell the mortgage it holds on 40 Wall St. at a distress price. The amount that Citi is owed on the 70-story building, once a holding of the late, great Ferdinand Marcos, is $80 million. The amount that it is willing to accept in payment, according to *Crain's New York Business*, is $20 million, or $20 a square foot. A source of ours relates that the offered side of the market is, in fact, lower; a spokeswoman for Citicorp declines to provide a number. If the cost of refurbishing the building to attract an institutional clientele is anything like $100 million (as Crain's reports), the building's true, economic value might well be less than zero. It would certainly be low enough to rattle the downtown real estate community.

Real estate is an admittedly slow and illiquid asset, but it isn't in every postwar cycle that tall buildings collapse on the heads of the billionaires who own them. Recently, David Shulman of Salomon Brothers predicted that the slump in commercial real estate may last, in some regions, until the end of the decade and that it will be 12 years before the national office vacancy rate returns to 5% from about 20% today. To equity investors who have become accustomed to measuring bear markets in terms of days, weeks or months, such a thing is almost beyond imagining.

Precedent is on Shulman's side, however, and the documentary evidence is available at the New York Public Library. One instructive story is that of the Equitable Building, 120 Broadway, a still-magnificent Wall Street skyscraper built in 1914-15. We've been reading up on the Equitable's past to try to reach a clearer understanding of the future. What we want to know is whether the realestate-related credit cycle is over or ending, or, as Shulman and others suggest, still unfolding. The answer to that question is easy: It is still unfolding. H. Dale Hemmerdinger, a reader and New York City property owner, contends that years of misery lie ahead as long-term leases are replaced by new, lower-cost leases. "Costs are front-end loaded," Hemmerdinger says. "Even if the market turns tomorrow (which it won't), it will take me a long time to get rid of my free rent, of my $30 to $50 work letters, and I've got to get my rents up. In the meantime, my costs are still going up.. . . What Olympia & York is looking for is a short-term solution. I don't know how that works."

The period selected for this investigation was the last glacial, deflationary bear market in New York City real estate, that of the 1930s. We skipped the 1970s bear market because it was an inflationary downturn, one that featured rising commodity prices and expanding bank credit. In the Depression era, occupancy rates and interest rates fell, and chastened lenders hung back from committing new funds. It has been a little like that in the 1990s, too. What is most interesting about the Equitable story, however, is what happened in the long succession of disinflationary years between the alleged return of prosperity in 1933 and the U.S. entry into World War II in 1941. The company stumped through the Depression only to seek bankruptcy protection at a time of relative prosperity. For those who like to use the stock market as a leading indicator of business activity, the failure occurred some nine years after the Dow Jones Industrial Average made its all-time low.

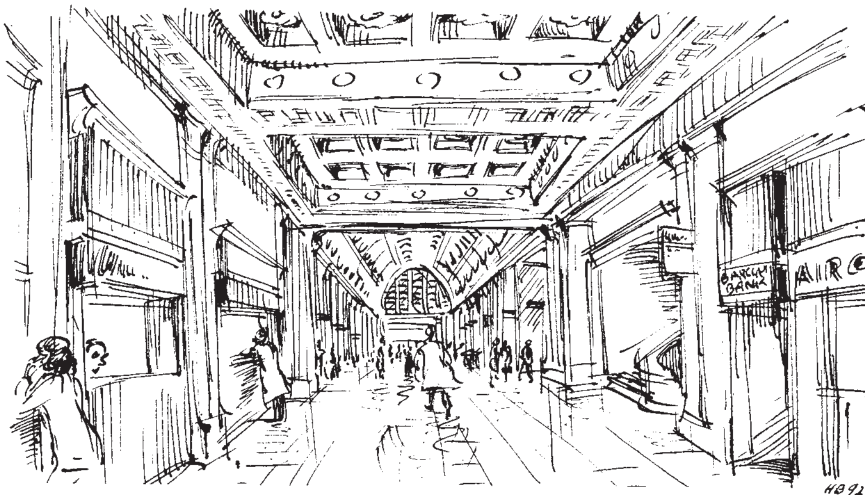
We are relating this story because it helps to convey a sense of the rhythm of a deflationary liquidation. It is slow motion, like a family reunion. If past is prologue, lessons from the 1930s may also apply to the 1990s (with certain modifications, of course, allowing for the mature welfare state, the full paper monetary standard and the possibility that the federal government may yet engineer a new inflation). For instance, construction activity will not make the hoped-for contribution to the next business expansion, real- estate losses will continue to weigh on banks and life insurance companies, and the patience of newspaper readers will be sorely tested. Like the man who came to dinner, Paul Reichmann might move onto the pages of *The Wall Street Journal* indefinitely. He and his lenders and their lawyers may carp and cavil and negotiate into the next millennium (but — to strike a bullish note — not into the one after that).

The best reason to study the Equitable Building is that the Equitable

Office Building Corp. was once an investor-owned company, and its financial history is available in *Moody's Banks & Finance*. The original Equitable Building burned to the ground in 1912 on the same Broadway site, and Coleman DuPont came up from Delaware to organize a corporation to put up a bigger and better successor building. No visitor to 120 Broadway is likely to quibble with management's appraisal (c. 1915) that the building, originally housing 1.2 million square feet, is "among the great business structures of this hemisphere." It was so great, in fact — 40 stories rising straight up from the building line without a single setback — that the shadows it cast on lower Manhattan galvanized a political movement to restrict the construction of anything so overpowering in the future. The Equitable Life Assurance Society of the United States gave DuPont a longterm, $20.5 million mortgage, one of the largest ever written up until that time. The interest rate was 4 1/2%.

It is impossible to appreciate the Equitable story without a proper respect for the building's gleaming place in the Wall Street skyline. "Emphatically, and unequivocably," said the original sales brochure, perhaps reflecting market conditions as well as management's sense of decency, "we will not make to one tenant, regardless of his size or his importance or his desirability, any concession which is denied to others." The capitalization of the Equitable Office Building Corp. was conservative, and the tenants were grade A. The fact that 4 1/2% eventually became an unmanageable rate of interest is a useful lesson in the relativity of nominal yields and the changeableness of rents. What seems low may later appear high, even oppressive; and, of course, vice versa.

The moral of the Equitable story is that a decline and fall takes time. In the roiled credit markets of 1930 and 1931; the Equitable Office Building Corp. 5s of 1952 were still quoted in the low 90s and mid 80s. In the nightmare year of 1931 — marked not only by a global liquidity crisis but also by a rash of real-estate foreclosures by New York savings banks and life insurance companies — the company showed a profit and comfortably covered its fixed charges; rental income was almost $6 million, or $5 a rentable square foot. After expenses, depreciation and taxes, net earnings totaled $2.4 million.



*The lobby of the Equitable Building. If only beauty could be capitalized.*

Cash on hand totaled $1.5 million. Altogether, it must have seemed to the Equitable's creditors as if the Depression were happening to somebody else.

In 1932, rental income dropped by less than 5%, earnings per share by a little more than 10%. The common dividend was cut to $2.50 a share from the old $3 rate, but at least there was a dividend. So far, so good.

If the phrase "world coming to an end" has ever pertained to the resilient American economy, it was descriptive in 1933. Rental incomes plummeted, and 25% of the mortgage investments of the major U.S. life insurance companies wound up in default. In that harrowing year, the Equitable Office Building Corp. was able to earn $1.4 million, or $1.54 a share, a testament to the quality of the tenancy and the long terms of the leases.

Inevitably, of course, leases came up for renewal. Some tenants did renew (others moved out and still others went bankrupt) and the new leases were signed at low, Depression-era rates. In 1933, rentals fell to an average of $4.16 a square foot. In 1934, they averaged $3.66 a square foot. Operating expenses and real-estate taxes happened to drop in 1934, but the capital expenditure program went on. Hoping to save on energy costs — the price of oil had vaulted by 71% in the first year of the Roosevelt recovery — management converted the building's oil-fired steam generating plant to anthracite coal power. Earnings in 1934 just topped the $1 million mark, or $1.25 a share, representing less than half of the 1931 rate. In the summer of 1934, the common dividend was omitted. It was reinstated at a lower rate in 1936: a false harbinger of recovery, it turned out.

The worst of the Depression was over, but rental income continued to fall as high-cost, 1920s leases were annually converted into low-cost, 1930s leases. (For 1920s and 1930s, of course, read 1980s and 1990s, respectively.) By 1936, the building's rental income amounted to just $2.68 a square foot, down by 46% from the levels prevailing in 1930. The Equitable Building's vacancy rate in the mid 1930s hovered around 15%. For perspective, the 1992 vacancy rate stands at 15.8%. Counting space available for sublease, it would amount to 20.5%. (We leave it to the real-estate scholars to determine the underlying cause of the decline of rents in lower Manhattan in the 1930s. Was it the still-weak national economy or overbuilding in the boom? Our bet is on the first hypothesis. In the 1920s, no self- respecting New York bank made real-estate loans.)

Periodically, but without great success, management petitioned the city for tax relief. The corporation paid $807,533 in real-estate taxes in 1935. It paid $788,800 in 1937 but $846,800 in 1939. War broke out in Europe in September 1939, and America became a haven for frightened money. It might have seemed to the average Wall Street investment strategist that a rally in rental income was imminent. But the building realized only $2.41 a square foot, on average, in 1939, and reported a net loss of $14,685, or two cents a share, its first annual deficit of the decade. It just barely covered fixed charges.

The company fell short in 1940, and

again in 1941; management gave up the ghost eight months before Pearl Harbor. "The [bankruptcy] petition said that, although the company would not be able to meet its current obligations as they fall due, it has an income and assets sufficient to make possible an equitable reorganization," Moody's reported.

The same slow, dream-like pace of activity continued during the reorganization proceedings — another cautionary precedent for today's lenders. Committees were formed, plans submitted and meetings held. Paul J. Isaac, the reader who inspired this piece, tells a story about one such proceeding. He says that he got the anecdote from his father. An arbitrageur named Lou Green, of the firm of Stryker & Brown, was questioned by an SEC examiner, Isaac relates. Asked what class of security holder he represented, Green did not reply "the debenture holders," "the senior mortgage holder" or "the preferred." What he said was, "the short interest in the common." Wartime prosperity notwithstanding, the vacancy rate in early 1942 was almost 14%. On July 10, 1942, Federal Judge J.C. Knox approved the purchase of a $16 million war and bombardment insurance policy for $16,000 a year. Rents and margins were down: The net loss grew.

As for the Equitable reorganization proceeding, it was conducted without undue haste. Competing plans of reorganization were submitted, and at least once the U.S. Circuit Court of Appeals reversed Judge Knox. By the time the final plan was confirmed, in October 1948, fees and allowances to the trustees and attorneys had piled up to $792,521. In November 1947, the building got a new, 25-year mortgage from the John Hancock Mutual Life Insurance Co. In place of the overbearing 4 1/2% interest rate was a reasonable 3.7% interest rate (which would later increase to 3 3/4%). The downward adjustment was just in time for the start of the long postwar rise in interest rates and also, of course, in rental rates. Still, the rent roll in December 1948 had returned only to an average of $3.47 a square foot, lower than the average for 1934.

Scrolling ahead a half century, to 1992, the Equitable Building is owned and managed by Silverstein Properties. A fund managed by J.P. Morgan Investment Management holds a participating mortgage on the property (entitling the creditors to a share of the cash flow). The lobby is still splendid, and the rentable area of the building is now put at 1.9 million square feet, an increase of 58% since the 1930s. According to a broker, the reasons for this miraculous growth relate, first, to the expandable definition of a square foot under New York law and, second, to the general tendency of potato chip bags to hold fewer chips every year. He implied that space inflation was in the air. As noted, the vacancy rate, not counting available sublease space, is 15%. One big tenant nowadays is the office of the New York State Attorney General; another is the law firm of Lester Schwab, Katz & Dwyer. The defunct Crossland Savings Bank occupies ground-floor space. Brokers say that deals can be struck at an effective rent of less than $22 a square foot over a 10-year lease for a 10,000-square-foot space. The number includes a work letter to finance construction and a certain amount of free rent. Neither Morgan nor Silverstein would comment on the economics of the building, but the numbers can only be bleak and — in view of the weakness of rents and the long-term nature of big-city leases — getting bleaker.

At a meeting of the New York Real Estate Board the other day, Larry A. Silverstein, head of Silverstein Properties, explained the real-estate profitand-loss dilemma, and the April 15 Real Estate Weekly gave this account:

> Silverstein said the real problem is that commercial rents are so low — the deals are not economically viable for the owners. He said operating expenses amount to $7 and $8 per square foot, real estate taxes are running from $7 to $11 per square foot, tenant work letters are at $5 per square foot and $1 is going for leasing expenses. This adds up to $21 per square foot before debt service, he said.
>
> Postwar building debt service averages $25 per square foot so Silverstein said owners need to see $46 per square foot just to break even. "In a $30 market," he said. "it's hard to see a profit and impossible not to incur a loss." In fact, he added, "There is no profit and the question is the magnitude of the loss."

In other words, losses loom indefinitely. If $21 per square foot is the average operating cost of a building before interest expense, it's a cinch that the owner of the Equitable Building is showing no profit after paying its lenders. "Quality projects in the end will become profitable," a vice president of Olympia & York Properties (Oregon) assured the Portland *Business Journal* recently. "It's just a matter of time." Based on the history of the Equitable Building, we would amend that claim. In a deflation, even quality projects will become unprofitable. It's inevitable.

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# *The economic consequences of air conditioning*

(June 4, 1999) On Wall Street's authority, the Internet is the most important innovation of all time. The brokers and bankers say this without qualification, and they would have us invest in the same spirit. In general, they advise the purchase of Internet stocks without regard for price or valuation on the ground that, to them, the principal long-term financial risk associated with the worldwide web is not being invested in it. Amazon.com, eBay, priceline.com, E*Trade, Charles Schwab et al. have purportedly already conquered the future, even though they haven't seen it yet. There are no visible competitive threats to these companies, the bulls contend. Supposedly, in fact, they are already as deeply entrenched in the U.S. economy as DuPont, General Motors and Procter & Gamble ever were.

We didn't believe these claims in cold weather. At the start of a New York summer, we are even more skeptical. To those who inhabit the hazy, hot and humid portions of the physical world, the Internet will never seem so seminal an invention as the low-tech room air conditioner. Visionaries may claim that the 'net will do nothing less than create new industries, refashion old ones, enhance productivity and rewrite the script of social, economic and political life the world over. Air conditioning has done all that, and more. Yet it has so far created no financial Garden of Eden, and we think we know the reason.

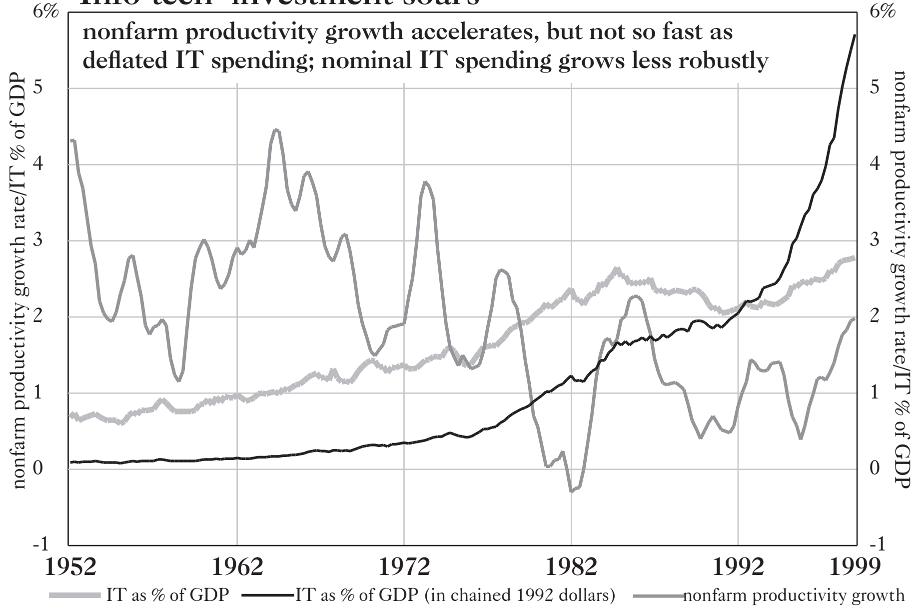
The destination of this essay is the idea that the consequences of technological upheaval are complex and unpredictable. Innovations make the world a more productive place, but also, simultaneously, in ways rarely anticipated, a less productive one. Thus, on the plus side, the Internet has unimaginably expanded the accessible store of human knowledge, up to and including bond analytics. On the minus side, it has brought day trading, e-mail and computer solitaire within the reach of every white-collar employee. It has facilitated the universal dissemination of American nuclear technology. All in all, we submit, the Internet's net contribution to U.S. productivity is considerably smaller than what is represented to be its gross contribution.

Revolutions, once begun, rarely proceed as the revolutionaries intended, and the chief beneficiaries of new inventions are not always the people who dreamt them up, invested in them or promoted them (they are sometimes the children or even the grandchildren of those individuals). Thus, for example, when Willis Haviland Carrier was awarded patent No. 808897 for an "Apparatus for Treating Air," on Jan. 2, 1906, the father of air conditioning almost certainly did not anticipate a future hole in the ozone layer or the political consequences of a 12-month congressional season. "The installation of air conditioning in the 1930s did more, I believe, than cool the Capitol," reminisced Rep. Joseph W. Martin, a Massachusetts Republican, in 1960, "it prolonged the sessions." Would American statism have come full flower in a non-air-conditioned capital city? Always, in technology, there are debits and credits.

To leapfrog over 2,500 or so well-chosen words, our top investment conclusions are, first, that innovation constitutes no certain warranty against macroeconomic turmoil and, second, that a margin of safety is just as essential in high-tech investing as it is in the low- and medium-tech kind. Thus, as we will observe, the truly stunning gains in productivity observed in the 1950s and 1960s were followed not by human perfection but by a great inflation. And as for the Internet, we hold it in such high regard that we believe it is fully capable of developing the means to destroy itself in favor of an information technology even more wonderful.

The basic Internet trade has so far been exquisitely simple: Obtain an allocation of an online IPO. Intermediate and advanced Internet trades—those derived from the second- and

**'Info-tech' investment soars**




sources: Gert von der Linde ; U.S. Dept. of Commerce

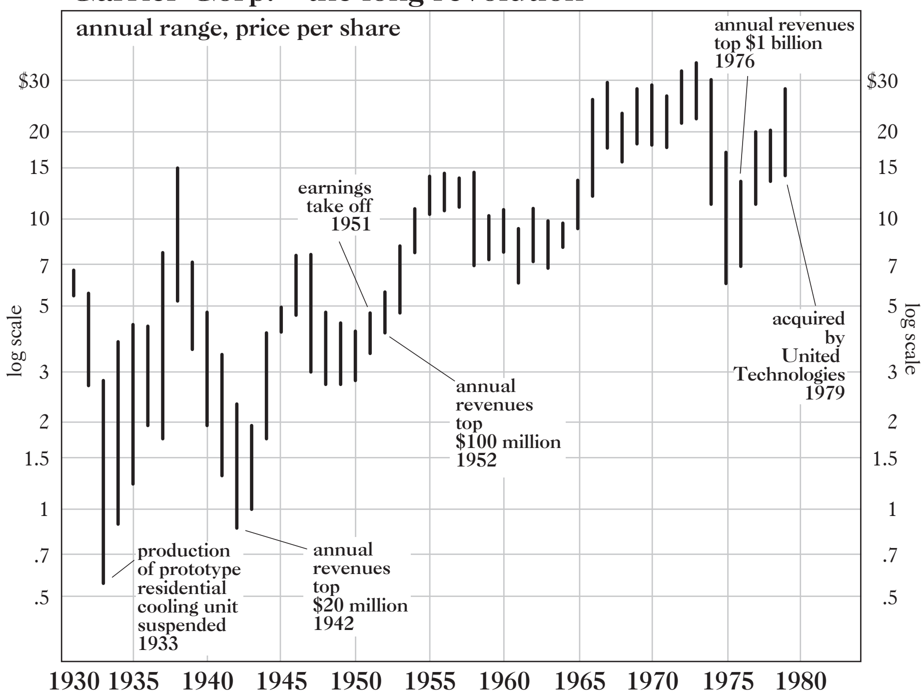
third-order effects of the 'net—will undoubtedly be subtler and more complex, e.g., sell the shares of the revolutionary businesses that the revolution has begun to devour; buy the shares of the Internet's surprise new beneficiaries; and—just a possibility—sell municipal bonds. An inkling of what the Department of Unintended Consequences might hold in store is the recent alarm expressed by states and municipalities over the loss of sales taxes to e-commerce. Say "Internet" and the first thought that comes to mind is not "public finance." Yet, what is apparently going through the minds of the members of the National Association of Counties and the U.S. Conference of Mayors is a future tax famine (with potential bearish consequences for tax-exempt debt). Knowing what he knows today, would Al Gore invent the Internet all over again?

The story of air conditioning, we think, speaks directly to the risks, opportunities, hopes and delusions of the digital age. Raymond Arsenault, in a brilliant essay entitled "The End of the Long Hot Summer: The Air Conditioner and Southern Culture" (first published in 1984 in *The Journal of Southern History*), observes that the great invention did not catch on at once: "The so-called 'air-conditioning revolution'. . . was actually an evolution—a long, slow, uneven process stretching over seven decades." A Brooklyn lithography plant was the first recipient of the Carrier apparatus, in 1902. Sales to a wide variety of industrial customers followed. But the so-called comfort market went uninvaded until the successful commercialization of centrifugal refrigeration, in 1922. When, on Memorial Day in 1925 Carrier successfully cooled the patrons of the Rivoli Theater, New York, a new day dawned. Yet almost 30 years would have to pass before the residential air conditioning market came into its own. Carrier himself wouldn't live to see it.

So unlike the digital revolution—or is it? Very much like it, in fact, with this difference: In 1999, the stock market willingly capitalizes loss-making companies. Through most of Carrier's career, it capitalized only profitable ones (or ones, at least, that started out profitably). "I fish only for edible fish," the inventor was wont to say, "and hunt only for edible game—even in the laboratory."

"[I]f you measure the progress of technology not by Mips and bytes but by how it affects people's lives and their ability to get useful work done," writes Paul Krugman in his book "The Accidental Theorist," "you realize that the last 30 years have been a time not of unexpected achievement but of persistent disappointment." Does the economist exaggerate? Not by the evidence presented in the accompanying graph. Note, first, the takeoff in "infotech" investment, i.e., capital investment in computers, semiconductors, telecommunications equipment, etc. The size of these outlays is depicted

## Carrier Corp.—the long revolution



Prepared for *Grant's Interest Rate Observer* by Topline Investment Graphics

in two ways, in current and constant dollars. In constant dollars, the expenditures increase gradually in the 1960s, sharply in the 1970s and 1980s and exponentially in the 1990s. In current dollars, there is no exponential liftoff. The reason for the flatter slope of the dotted line is the ferocious info-tech price deflation. Without an adjustment for falling prices (and rising imputed product performance, whether or not the user can actually make use of it), growth in information-related technology investment looks merely brisk, not world-beating.

The same, in fact, might be said for growth in nonfarm productivity, depicted by the third line. For a supposed New Era, the rate of improvement in output per man hour over the past few years may seem to you (as it does to us) mystifyingly slow, even following the 1996 upturn. Gert von der Linde, the unofficial *Grant's* house economist, observes that the recovery of the past three years is itself highly unusual. As a rule, major accelerations in productivity growth begin at the bottom of recessions, not in mid-boom. By way of preface, von der Linde advises that all these numbers be taken with a grain of salt, as the concept of national income accounting is less than 70 years old. However, he goes on, taking the statistics on their face, one can see that growth in productivity is far below the rates observed throughout much of the 1950s and 1960s (despite some ups and downs, growth in nonfarm output per man hour in those two decades averaged 2.8%).

Which returns us to the story of the life and times of Willis H. Carrier. What was responsible for the productivity bulge of the Eisenhower, Kennedy and Johnson eras? The first UNIVAC computer entered service in 1951, the Boeing Dash 80 (prototype of the 707 jetliner) debuted in 1954, legislation creating the interstate highway system was signed by President Eisenhower in 1956 and the Xerox 914 copier came on the market in 1960. And it was in the fabulous '50s that residential air conditioning became a fixture.

It may give heart to the speculators in Amazon.com, eBay, priceline.com and other first-generation Internet businesses to know that Carrier Corp. is today, as it was at the time of Willis Carrier's death in 1950, the undisputed air conditioning leader. York Corp., Frigidaire, Trane Co. and Westinghouse (to name only part of the competitive field) never overtook it.

On the other hand, if you plot the stock price of Carrier in terms of the Dow Jones Industrial Average from 1929 until 1979 (when it was acquired by United Technologies), you find no prolonged outperformance. Many were the bumps on the road to a room-temperature world. In about 1933, according to a biography of the founding genius, Carrier was forced to suspend production of its prototype residential room cooling unit. There was no demand. Yes, the bulls will counter, but that was the Depression. Yes, we reply, but air conditioning did not prevent the Depression. (*Fortune* would call air conditioning "a prime public disappointment of the 1930s.") Innovation alone does not drive the world economy.

Only the most patient and long-lived air conditioning bulls were on hand to be fully vindicated. "In 1945," relates Arsenault, "in a preview of things to come, shipping magnate Henry Kaiser announced plans to build 'complete communities of mass-produced air conditioned homes....' Room air-conditioner sales climbed to over 40,000 by 1947, but at that period residential air conditioning still accounted for only 2% of the industry's business. By 1950 the figure had risen to 5%, but in most areas the air-conditioned home remained a novelty."

Not long ago on First Call, a brokerage-house analyst pronounced eBay to be cheap at 55 times net income projected for the year 2009. Such an expression of faith—in the permanence of a new technology, in the capacity of a new company to exploit it, in the predictability of the future, in the stability of civilization as we know it—appears on Wall Street only cyclically. It is in the shortest supply when it ought to be most plentiful, i.e., when values are cheap. It was conspicuously not in evidence in 1951, at the start of the home air conditioning age.

What then stood in the way of an air-conditioning stock boom was not the future but the past, the memory of bad things and the dread of more. If the market doubts nothing today, it believed nothing then. In the summer of 1951, the Dow had made a 20-year high, at 263. Then, again, it was only back to where it stood in the depression year of 1931.

"In 1951," historian Arsenault proceeds, "the inexpensive, efficient window unit finally hit the market, and sales skyrocketed, especially in the South." "With a growing population," wrote John C. Perham in *Barron's* in August 1951, "a rising standard of living, a slow but diabolical increase in yearly temperatures, and more powerful and adaptable air conditioning equipment all converging to rout any obstacles, it is hard to see serious trouble ahead for the industry." What *Barron's* didn't get around to mentioning was that Carrier Corp. traded at 5.2 times trailing net income and 2.4 times the annualized net income of its latest fiscal quarter. Then, too, at a price of 23fl, the stock yielded 4.2% (long-dated Treasurys fetched 2.65%).

What digitally awaits us in the near future, we keep reading, are breakthroughs in "user interfaces" as well as communication and computing technologies. Thus, writes Richard Rowe in the April 9 edition of the *Boston Business Journal*, "In the next decade, we will see electronic ink, heads-up, hands-free displays, smart, personalized and voice-controlled appliances and mind-machine connections that will transform the way knowledge is generated, accessed and used more than any innovation since the advent of print."

Wonderful, certainly, but not clearly so wonderful as a technology that actually changed American migration patterns, that caused the "Sunbelt" to rise up out of sand and scrub and that immeasurably increased human comfort and health from Jakarta to Baltimore. Who could enjoy a life of digital interactivity with sweat pouring into his eyes?

It will be said that the Internet has revolutionized not the world of the body but the life of the mind. However, we feel, the mind is receptive to only so much revolution. Reyner Banham, in "The Architecture of the Well-tempered Environment," published in 1969, observed that air conditioning, along with electric lighting, had rendered "all environmental constraints on design" obsolete. In the new age, you could live anywhere you wanted to, and in any kind of house (thank you, John Newman).

Yet, Banham went on, "[T]he possibility of absolute variety and infinite choice of building form is now with us—and as so often happens with infinite choices, has led to almost perfect homogenization of what is chosen. In the United States, air-conditioning has now made the established lightweight tract-developers' house habitable throughout the nation, and since this is the house that the U.S. building industry is geared to produce above all others, it is now endemic from Maine to California. . . ."

Proponents of the Internet hold out the vision of infinite variety in ideas. To which we say: Not in this life. As in suburbia, so online. On the web, the people's choice in financial information turns out to be a kind of intellectual tract house. A telling case of web-borne homogeneity is the ubiquitous online "company snapshot." You might suppose, reflects Lawrence Sterne, CEO of Wall Street Research Net, that the Internet would have evolved a corporate financial summary superior to that in the old S&P ring binders. It hasn't. Furthermore, he notes, everybody tends to have the same snapshot: "You've got to have it because everybody else has it." It's not that there is no unique online financial content, Sterne goes on. The problem is that what there is is so narrowly distributed.

We leave it up to the readers of *Grant's* to decide for themselves how much of the experience of managing money is emotional and how much is analytical (the emotional content is not more than 90%, in our experience). And the Internet has become the superhighway of speculative emotion. What a digitally enhanced bear market will look like we may all worry about or pine for. Certainly, the digitally enhanced bull market has been one for the record books. Speaking of his extensive experiences online, William A. Fleckenstein, professional money manager and columnist on the Silicon Investor website, observes, "There is a fundamental belief that information is knowledge. It isn't."

All in all this summer, we'll take air conditioning.

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## *Emulate Henry Singleton*

(February 28, 2003) Something went haywire with American capitalism in the 1990s, and we think we know what it was. There weren't enough Henry E. Singletons to go around. In truth, there was only one Singleton, and he died in 1999. He could read a book a day and play chess blindfolded. He made pioneering contributions to the development of inertial navigation systems. He habitually bought low and sold high. The study of such a protean thinker and doer is always worthwhile. Especially is it valuable today, a time when the phrase "great capitalist" has almost become an oxymoron.

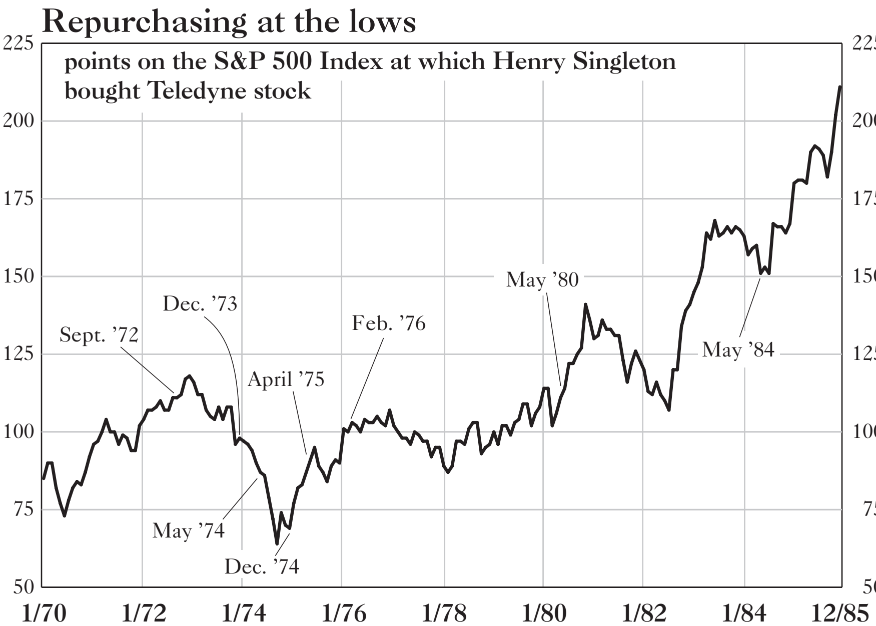
Singleton, longtime chief executive of Teledyne Inc., was one of the greatest of modern American capitalists. Warren Buffett, quoted in John Train's "The Money Masters," published in 1980, virtually crowned him king. "Buffett," Train reported, "considers that Henry Singleton of Teledyne has the best operating and capital deployment record in American business."

A recent conversation with Leon Cooperman, the former Goldman Sachs partner turned portfolio manager (he's the managing general partner of Omega Partners), was the genesis of this essay. It happened in this fashion: Cooperman was flaying a certain corporate management for having repurchased its shares at a high price only to reissue new shares at a low price. He said that this was exactly the kind of thing that Singleton never did, and he lamented how little is known today of Singleton's achievements as a capital deployer, value appraiser and P/E-multiple arbitrageur. Then he reached in his file and produced a reprint of a critical *Business Week* cover story on Teledyne. Among the alleged missteps for which Singleton was attacked was his heavy purchase of common stocks. The cover date was May 31, 1982, 10 weeks before the blastoff of the intergalactic bull market.

The wonder of Singleton's life and works is the subject under consideration—admittedly, a biographical subject, as opposed to a market-moving one. We chose it because Singleton's genius encompassed the ability to make lemonade out of lemons, a skill especially valuable now that lemons are so thick underfoot.

Singleton was born in 1916 on a small farm in Haslet, Texas. He began his college education at the U.S. Naval Academy but finished it at M.I.T., earning three degrees in electrical engineering: bachelor's and master's degrees in 1940, and a doctorate in 1950. In 1939, he won the William Lowell Putnam Intercollegiate Mathematics Competition Award. In World War II, he served in the Office of Strategic Services. At Litton Industries, in the early 1950s, he began his fast climb up the corporate ladder: by 1957, he was a divisional director of engineering. In 1960, with George Kozmetsky, he founded Teledyne.

Anyone who was not reading The *Wall Street Journal* in the 1960s and



source: The Bloomberg, Leon Cooperman

1970s missed the most instructive phase of Singleton's career. When the Teledyne share price was flying, as it was in the 1960s, the master used it as a currency with which to make acquisitions. He made about 130. Many managements have performed this trick; Singleton, however, had another: When the cycle turned and Teledyne shares were sinking, he repurchased them. Between 1972 and 1984, he tendered eight times, reducing the share count (from high to low) by some 90%. Many managements have subsequently performed the share-repurchase trick, too, but few have matched the Singleton record, either in terms of market timing or fair play. Singleton repurchased stock when the price was down, not when it was up (in the 1990s, such icons as GE, IBM, AOL Time Warner, Cendant and, of course, Tyco, paid up—and up). He took no options awards, according to Cooperman, and he sold not one of his own shares. Most pertinently to the current discussion of "corporate governance," he didn't sell when the company was buying (another popular form of managerial self-enrichment in the 1990s).

The press called him "enigmatic" because he pursued policies that, until the mists of the market lifted, appeared inexplicable. For example, at the end of the titanic 1968-74 bear market, he identified bonds as the "high-risk asset" and stocks as the low-risk asset. Accordingly, he directed the Teledyne insurance companies to avoid the former and accumulate the latter. To most people, stocks were riskier, the proof of which was the havoc they had wreaked on their unlucky holders during the long liquidation.

Some were vexed that, for years on end, Teledyne paid no dividend. The master reasoned that the marginal dollar of corporate cash was more productive on the company's books than in the shareholders' pockets, and he was surely correct in that judgment. Teledyne's stable of companies (many in defense-related lines, others in specialty metals, offshore drilling, insurance and finance, electronics and consumer products, including Water-Pik) generated consistently high margins and high returns on equity and on assets.

Singleton made his mistakes, and Teledyne's portfolio companies made theirs. A catalog of some of these errors, as well as not a few triumphs misclassified as errors, appeared in the *Business Week* story. We linger over this 21-year-old piece of journalism because it illustrates an eternal truth of markets, especially of markets stretched to extreme valuations. The truth is that, at such cyclical junctures, doing the wrong thing looks like the right thing, and vice versa. In the spring of 1982, few business strategies appeared more wrongheaded to the majority of onlookers than buying the ears off the stock market.

On the *BW* cover, the handsome Singleton was portrayed as Icarus in a business suit, flying on frail wings of share certificates and dollar bills. The article conceded that the master had done a pretty fair job for the shareholders, and it acknowledged that the share repurchases had worked out satisfactorily—to date. They had, in fact, boosted per-share earnings "and also enabled Singleton, who held on to his own Teledyne shares, to amass 7.8% of the company's stock." He was the company's largest shareholder and its founding and indispensable brain.

Yet the magazine was not quite satisfied, for it perceived that Singleton had lost his way. For starters, it accused him of having no business plan. And he seemed not to have one. He believed, as he later explained at a Teledyne annual meeting, in engaging an uncertain world with a flexible mind: "I know a lot of people have very strong and definite plans that they've worked out on all kinds of things, but we're subject to a tremendous number of outside influences and the vast majority of them cannot be predicted. So my idea is to stay flexible." To the *BW* reporter he explained himself more simply: "My only plan is to keep coming to work every day" and "I like to steer the boat each day rather than plan ahead way into the future."

This improvisational grand design the magazine saw as the "milking" of tried-and-true operating businesses and the diverting of funds to allow the chairman to "play" the stock market. A *BW* reader could imagine Singleton as a kind of Nero watching Rome burn while talking on the phone with his broker. He didn't invest in businesses, the magazine suggested, only in pieces of paper. He either managed too little (as with the supposedly aging and outmoded operating companies) or too much (as with the insurance businesses, where, according to *BW*, he managed to no great effect). His reserve was "icy."

Singleton's disdain for the press was complete and thoroughgoing: The *BW* article just rolled off his back. It puzzled him that his friend Cooperman would bother to draft a nine-page rebuttal, complete with statistical exhibits. Why go to the trouble? Cooperman, who has fire where Singleton had ice, wanted the magazine to know that, during the acquisitive 1960s, Teledyne's sales and net income had climbed to about $1.3 billion and $58.1 million, respectively, from "essentially zero," and that during the non-acquisitive 1970s, profit growth had actually accelerated (with net income of the 100%-owned operating businesses rising sixfold).

As for those share repurchases, Cooperman underscored an achievement that appears even more laudable from the post-bubble perspective than it did at the time. "Just as Dr. Singleton recognized [that] he had an unusually attractive stock to trade with in the 1960s," wrote Cooperman, "he developed the belief that the company's shares were undervalued in the 1970s. In the period 1971-1980, you correctly point out that the company repurchased approximately 75% of its shares. What you did not point out is that despite the stock's 32% drop from its all-time high reached in mid-1981 to the time of your article, the stock price remains well above the highest price paid by the company (and multiples above the average price paid) in this ten-year period." And what Cooperman did not point out was that none of these repurchases was earmarked for the mopping up of shares issued to management. He did not point that out, probably, because the infamous abuses of options issuance still lay in the future.

*Business Week*, however, was right when it observed that nothing lasts forever and that Singleton couldn't manage indefinitely. In 1989, he formally relinquished operating control of the company he founded (and, by then, owned 13.2% of). Even then it was obvious that the 1990s were not going to be Teledyne's decade. Appended to The *Wall Street Journal*'s report on Singleton's withdrawal from operations was this disapproving note: "The company hasn't said in the past what it plans to do. It doesn't address analyst groups or grant many interviews. Teledyne's news releases and stockholder reports are models of brevity. Some securities analysts have given up following the company because they can't get enough information." Imagination cannot conjure a picture of Singleton on CNBC.

The dismantling of Teledyne began in 1990 with the spin-off of the Unitrin insurance unit (later came the sale of Argonaut, another insurance subsidiary). Singleton resigned the chairmanship in 1991, at the age of 74. Presently, the financial results slipped, the defense businesses were enveloped in scandal and Teledyne itself was stalked as a takeover candidate. Surveying the troubles that came crowding in on the company after the master's departure (and—unhappily for the defense industry—after the fall of the Berlin Wall), *Forbes* magazine remarked: "For many years Henry Singleton disproved the argument that conglomerates don't work. But it turns out Teledyne was more of a tribute to Singleton than to the concept."

In retirement, Singleton raised cattle and became one of the country's biggest landowners. He played tournament chess. "Most recently," according to a tribute published shortly after his death (of brain cancer, at age 82), he devoted much time to computers, programming algorithms and creating a fine computer game of backgammon. . . ."

To those not attuned to the nuances of corporate finance, Singleton's contribution appeared mainly to concern the technique of share repurchases. Thus (as an obituary in the Los Angeles Times had it), Teledyne was the forerunner to the white-hot growth stocks of the Clinton bubble, including Tyco International and Cendant. Singleton knew better. To Cooperman, just before he died, the old conglomerateur confided his apprehension. Too many companies were doing these stock buybacks, he said. There must be something wrong with them.

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## *The 29th bubble*

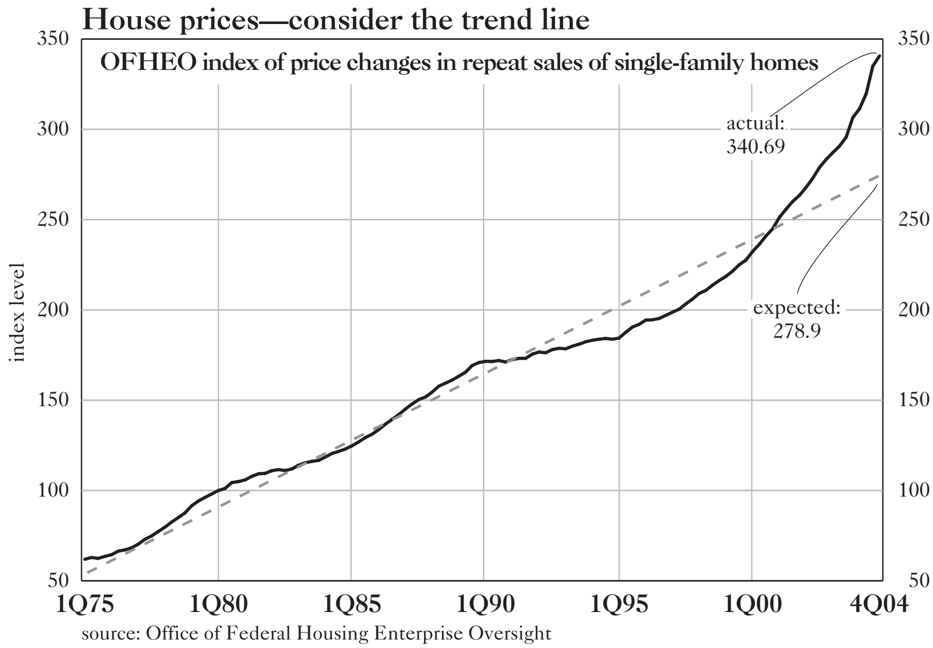
(June 3, 2005) "We don't perceive that there is a national bubble," Alan Greenspan, speaking about house prices, advised the Economic Club of New York the other day, "but it's hard not to see . . . that there are a lot of local bubbles." For what might be the first time in his life, the Maestro thereby staked out a genuinely contrary investment position. These days, bearishness on house prices has become an Approved Institutional Opinion, much like bullishness on almost everything else.

Following is a new contribution to the negative literature. We do not mean to be repetitive, or—worse yet—banal, and we believe we are not. One proof we offer is the title of an essay by the real-estate authority we are about to quote. It is: "Growth of Dolphins, *Coryphaena Hippurus and C. Equiselis*, in Hawaiian Waters as Determined by Daily Increments on Otoliths" (Fishery Bulletin, U.S. Department of Commerce, Vol. 84, 1986). Which other expert on U.S. house prices could make an even remotely similar claim? The author's view, and ours, is that, in residential real estate from Miami to Seattle, "bubble" is the word.

It's not a word just to toss around. A bubble market is one that goes way, way up, then comes way, way down. And house prices have gone way, way up—in April, the median existing home price showed a year-over-year gain of 15%. But they have not come way, way down. Indeed, the national average has not registered a broad-based decline in living memory. Since the 1930s, sideways is as bad as a bear market in American residential real estate has gotten (though there have been some ferocious localized declines). "[H]istory is definitive," pronounced the *American Banker* in a May 23 article on interest-only mortgages, "The national average price of a home may remain relatively flat for a number of years, but it doesn't fall." Let's see about that.

If the 2005 U.S. residential real estate market were in a bubble, and if prices did not subsequently fall, that would constitute a first. A bubble is a defined phenomenon; not just any frothy market makes the grade. According to the analysts at GMO, Boston, a bubble is a two standard deviation event, and they have identified only 28 of them since the Coolidge bull stock market.

Physicists rightfully smile at the pretensions of Wall Street's quants. But, in the matter of bubbles, the financial analysts may have discovered an actual law of nature. In 27 of the 28 cases, according to GMO, sky-high prices eventually returned to earth, frequently making a small crater as they landed. The one known outlier is the 28th and current bubble, the S&P 500, which would have to fall to about 750 to revert to the mean (it closed Tuesday at 1,192). "Have to fall," in fact, is not quite accurate. By trading sideways for a decade or so, the S&P might revert to trend with a whimper, not a bang. So, the question that should absorb us all: Are U.S. house prices in that kind of a market?



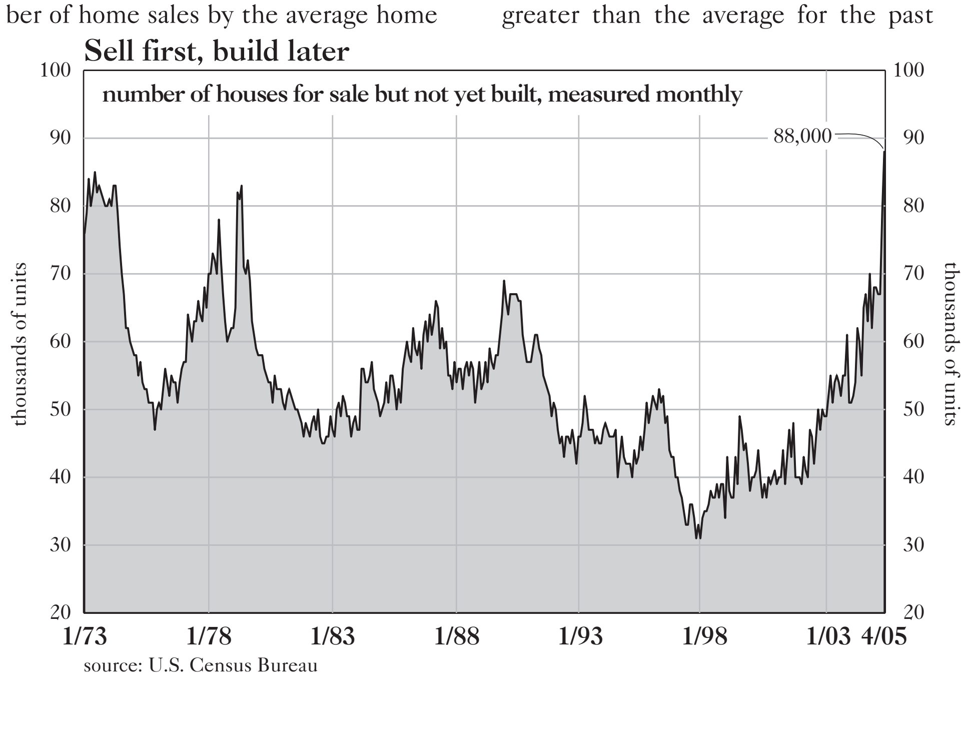

We base our affirmative reply on many things, including the proliferation of no-money-down and interest-only mortgages; the soaring growth in the volume of new houses for sale, which houses do not yet happen to exist; and the growing imbalance between rising supply and sated demand. As for the second and third items on the list, students should consult a May 25 report by Francois Trahan et al. of Bear Stearns, "REIT All About It: A Bubble Looming in Real Estate?" Trahan's thesis is that 2005 is a uniquely risky juncture in real estate. Never before have homeowners been so leveraged; and never before has the residential market been so speculative. And, yes, he's bearish on REITs.

Which brings us to the centerpiece of the investment case against houses. R. King Burch, the originator of the forthcoming analysis, is a paid-up subscriber in Honolulu. As might be inferred from the title of the scientific essay quoted above, he was trained as a marine biologist, but made a career switch to real estate (he was intrigued to discover in business school that investment mathematics resemble the math used to express the dynamics of fish populations). He participated in the Japanese-financed Hawaiian property bubble of 1988-90, worked on hotel deals in Florida in the 1990s and wrote—among other real-estate-relevant works—"The Internal Contradictions of Hotel Real Estate Investment Trusts" (*Real Estate Review*, Fall 1997). Today, he consults and invests for himself in Hawaii. Either house prices are in a bubble, Burch advises, or, if not that, "at least something very different from the usual home buying activity that goes on in the U.S. economy."

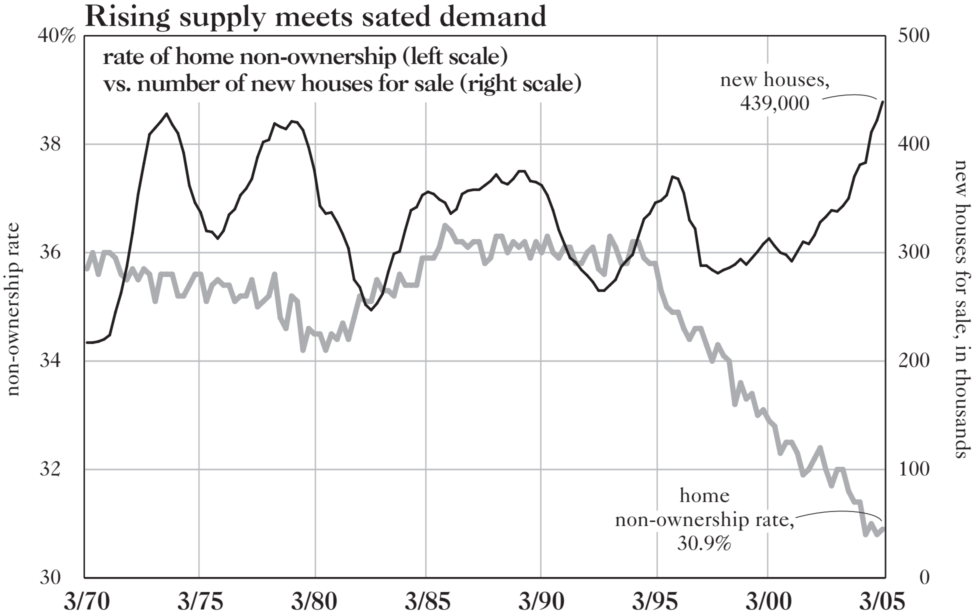
We believe that Burch has proven the bubble case, with all it implies for a future slump in the prices of the roofs over our heads. Like many another eureka, this one is calculated to make the reader say, "Now why didn't I think of that?" To draw a bead on U.S. real estate activity, Burch suggests, just take price times volume: Multiply the number of home sales by the average home price. Now divide that value by GDP. The answer expresses the intensity of house fever. Call this measure, as Burch does, the "calculated transaction value," or CTV. Now examine the findings, 1970 to date, plotted nearby. Do you spy a bubble?

For 35 years, 1970 to 2005, the annual CTV—price times volume, both of existing and new houses—averaged just under 9.2% of GDP. "However," Burch relates, "the data show two periods with remarkable divergences from this mean. The first such period occurred in the inflation-led housing frenzy of the late 1970s, when transactions jumped from early-decade values of around 7% and peaked at nearly 12% in 1978. However, a nudge from Paul Volcker and 16% mortgage rates sent it plummeting back down to 6% of GDP by 1982." Significantly, Burch goes on, the decline was owing not to any fall in average prices, but to a 50% plunge in the number of sales: "Housing transactions then spent the next 15 years ranging from about 8% of GDP to just under 10% of GDP."

The breakout year for the current house-price boom is 1998. Except for a small stumble in 2000, the CTV has made a succession of new highs. It reached 16.2% in 2004, "a proportion," notes Burch, "that is 73%, and 2.95 standard deviations, greater than the average for the last 35 years." Not stopping there, it touched 17.2% at the end of the first quarter of this year, a level 85%, and 3.4 standard deviations, greater than the average for the past



**Rising supply meets sated demand**




source: The Bloomberg

$35\frac{1}{4}$ years. If house prices are not a bubble, house transactions certainly are. Does your brother-in-law, the real estate broker, owe you money? Now is the time to collect.

One might suppose that low mortgage rates are a sufficient condition for bubbling house prices. Burch finds otherwise: "A simple regression shows that average annual interest rates on conventional loans explain only about 30% of housing activity expressed as a percentage of GDP." Only consider 2004: CTV soared as mortgage rates stayed the same. Nor is the driving force behind the real estate bull market elevated income growth. Since 2000, growth in nominal wages and salaries has averaged 2.7% a year (5.9 percentage points lower than annual average growth since 2000 in the median price of an existing house).

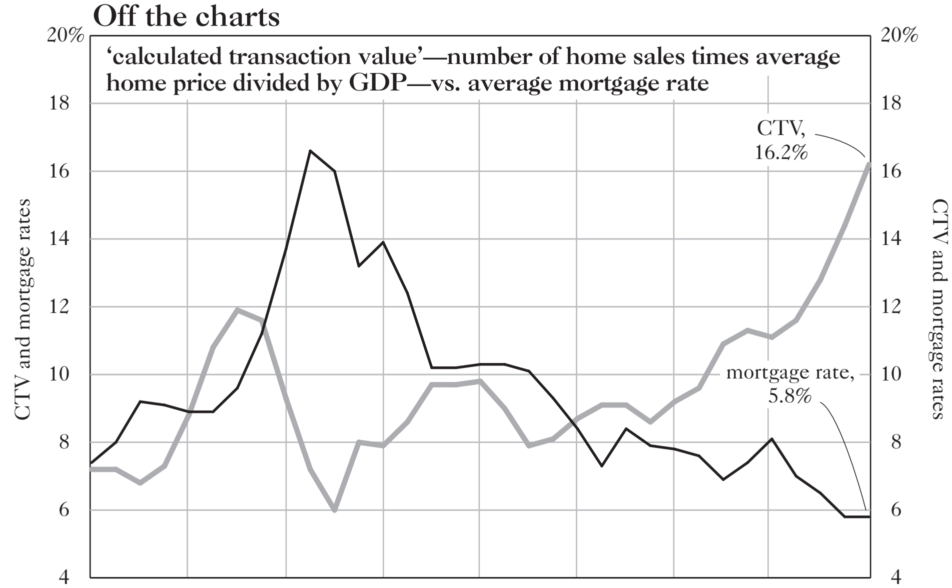
What has driven the boom is rather the accessibility of dollars. For this monetary superabundance, the revolution in securitized mortgage finance, specifically the post-2000 lift-off in MBS activity, deserves thanks. Comments Burch: "The relatively recent advent and growth of an international market in mortgage-backed securities, whose buyers are neither especially knowledgeable of, nor concerned with, the credit and collateral of the borrower trumps the claim, valid in quaint earlier times when a neighborhood lender made and held local loans, that real estate markets are local." And while you're at it, thank the so-called carry trade (the tactic of borrowing at a low rate and investing at a higher, longer-term rate) and the shape of the yield curve (short rates conveniently below longer ones).

In times past, the home buyer had to apply for a loan. Now, the lenders almost apply to him, whoever he is. Can you fog a mirror? But wait, Burch cautions. A subprime-grade borrower availing himself of a no-money-down, interest-only mortgage confronts daunting arithmetic. Besides mortgage expense—call it 5% a year—the buyer must bear the cost of property taxes, upkeep and utilities—call that $2\frac{1}{2}$% a year. And say, at the end of year one, he decides to sell. He must pay a sales commission and other closing costs—call that 6.5% of the purchase price. Just to break even, therefore, our buyer-speculator requires 15% in price appreciation (calculated as [1.00 + 0.05 + 0.025/0.935]).

"Home prices and financing cannot continuously diverge from the buyer's ability to pay," Burch winds up. "Even the most aggressive MBS investors must eventually balk at funding towering home prices when the buyer has no 'skin' in the game. Since mortgage rates have, generally, stopped declining, I would bet (in fact, I have bet, by purchasing put options on home builders) that the game has already peaked." And the flatter the yield curve becomes, the tighter the lender's margins and the greater his risk.

We led off this article with the concession that bears on houses are thick on the ground. But how many of these doubters have taken bearish action? Your house-owning editor has not. The bearish Francois Trahan (co-author of the Bear Stearns report) advises against precipitous action: "[T]here's no need to rush for the exits just yet; i.e., real estate, unlike stocks, is a slow-moving asset and none of this will unfold overnight." And from one of the top Wall Street research houses comes this optimistic article of pessimism: "[H]ousing is in a bubble, but [eminent economist's name withheld] places us in the seventh inning with plenty of upside potential." As long as interest rates stay moored, what's the rush?

**Off the charts**




sources: R. King Burch, Freddie Mac

## 'Club Med'
### deficits and debts measured as a percentage of GDP

| | Greece | | Italy | | Portugal | |
|---|---|---|---|---|---|---|
| | deficit | debt | deficit | debt | deficit | debt |
| 1994 | -9.4% | 107.9% | -9.3% | 124.8% | -6.6% | 62.1% |
| 1995 | -10.2 | 108.7 | -7.6 | 124.3 | -4.5 | 64.3 |
| 1996 | -7.4 | 111.3 | -7.1 | 123.1 | -4.0 | 62.9 |
| 1997 | -4.0 | 108.2 | -2.7 | 120.5 | -3.0 | 59.1 |
| 1998 | -2.5 | 105.8 | -2.8 | 116.7 | -2.6 | 55.0 |
| 1999 | -1.8 | 105.2 | -1.7 | 115.5 | -2.8 | 54.3 |
| 2000 | -4.1 | 114.0 | -0.6 | 111.2 | -2.8 | 53.3 |
| 2001 | -3.6 | 114.8 | -3.0 | 110.7 | -4.4 | 55.9 |
| 2002 | -4.1 | 112.2 | -2.6 | 108.0 | -2.7 | 58.5 |
| 2003 | -5.2 | 109.3 | -3.1 | 106.3 | -2.9 | 60.1 |
| 2004 | -6.1 | 110.5 | -3.1 | 105.8 | -2.9 | 61.9 |
| 2005e* | -4.5 | 110.5 | -3.6 | 105.6 | -6.8 | 66.2 |

*European Commission forecasts
source: Eurostat

But maybe the immediate risk to house prices lies not with interest rates but with lending standards, or the shape of the yield curve. Recall, as does Paul Kasriel, director of economic research at Northern Trust Co., the May 16 "guidance" from a brace of federal regulatory agencies to the nation's mortgage makers. The points of risk singled out by the bureaucrats are the very ones that have empowered the marginal home buyer to stretch to buy the marginal home (they include interest-only loans, high loan-to-value loans, low—or no—documentation loans and proliferating home-equity loans). A friend observes that the Fed resisted entreaties late in the 1990s to tighten margin requirements to deflate the stock-market bubble. Not literally deaf to its critics, the Fed—and the other leading federal banking regulators—might just be trying to take some of the helium out of today's bubble in house prices. It's no easy thing to deflate just a little bit. Good luck, *federales*!

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# *Inside ACE Securities' HEL Trust, Series 2005-HE5*

(September 8, 2006) The nation is running out of magazine covers on which to announce the coming collapse of house prices. From which fact it could be inferred that Mr. Market is running out of sellers of the statistically cheap housing stocks. Is there even one surviving bull on Toll Brothers or Countrywide Financial or New Century Financial Corp. who doesn't know that the house-price bubble has burst?

Maybe not. But the news has strangely failed to register in the mortgage-backed securities market. For the buyers of CDOs, HEL trusts, RMBS and every other alphabetic variation on the words "mortgage debt," the year might as well be 2004, not 2006. As far as the bond bulls seem to know, house prices are still climbing, homeowners are still painlessly extracting cash from their bricks and granite countertops, and foreclosures are just a tiny cloud in an otherwise clear blue sky. The worse the news from the home front, the closer mortgage yields seem to hug the Treasury yield curve—and the more determined the bidding by Wall Street's asset-backed securities mills for First Franklin, Saxon Capital and the other mortgage originators lately put on the auction block. (The world returned to its desk after the Labor Day weekend to discover that Merrill Lynch had agreed to buy National City Corp.'s home-mortgage subsidiary for $1.3 billion.)

This paradox is the subject at hand. Our approach is at once bottom-up and top-down: a clinical examination of the mortgage security named in the headline as well as a review of the micro and macro forces that have contributed to its stunning overvaluation. Now the cat's out of the bag. "Overvalued," we, in fact, judge trillions of dollars of asset-backed securities and collateralized debt obligations to be, and we are bearish on them. Housing-related stocks may or may not be prospectively cheap; they at least look historically cheap. But housing-related debt is cheap by no standard of value. For institutional investors equipped to deal in credit default swaps, there's an opportunity to lay down a low-cost bearish bet.

The sheer volume of issuance of non-Fannie and non-Freddie residential mortgage-backed securities may surprise you. In the first six months of this year, $303 billion was minted vs. $490 billion in all of 2005. As recently as 2000, such issuance totaled a mere $58.5 billion. If you've guessed that there's money to be made in the creation and distribution of these mortgage conflations, you're well on your way to penetrating the mystery of why the Bloomberg/Bear Stearns Home Equity HELOC Index is trading at the tightest spread to the Treasury curve in the past 10 years (for ocular evidence, see page 2).

A Moody's managing director, John Kriz, helped to sort things out in a recent article in the *American Banker*. Why, he was asked, is the value of M&A activity in mortgage-origination businesses on its way to hitting a decade high? Why are Wall Street's best and brightest so keen to own the companies that lend against the no-longer gold-plated collateral of residential real estate?

"If you have a significant distribution platform," replied Kriz, "there are many things you can do to move those assets—through securitizations and outright resale, among other things. What you need is product to feed the machine." This machine is one of Wall Street's most treasured. It processes mortgages into asset-backed securities and ABS tranches into collateralized debt obligations and CDO tranches into CDOs squared (a CDO squared is, of course, a CDO of a CDO). It is a wondrous kind of machine that spits out fees for its owners at every step of the manufacturing process.

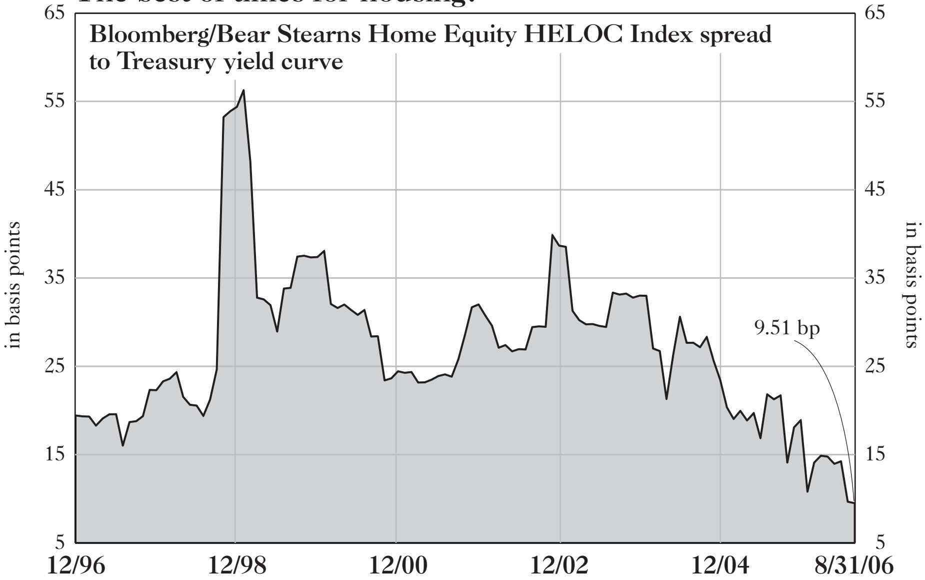
Last month, Reuters took note of the burgeoning sale of home equity loans packaged as asset-backed securities. The story quoted a practitioner who ascribed the surge to a parallel boom in the issuance of a kind of mortgage insurance. The insurance in question is the credit default swap, a common enough item in the corporate and sovereign debt markets but a late arrival in the mortgage market. Nowadays, a qualified investor can buy a CDS on a particular mortgage-backed bond and even a specific particular tranche of that security. In the language of Wall Street, the CDS buyer is a "buyer of protection." The cost he pays is an interest rate, and the party to which he pays it is the seller of protection. "With the advent of the synthetic market," observed the Reuters expert, "there are tremendous amounts of home equity risks being traded, much of which is driven by the CDO desire to sell protection in their structures."

This last comment explains more than it might seem. To see it for the revelation that it is, a layman may need to pause to catch his breath and review some basic nomenclature. Recall, to start with, that a CDO is a pile of debts refashioned into a security. It is structured in slices, or tranches, from supposedly bulletproof (triple-A) to admittedly perilous (speculative-grade or not-rated). It is highly leveraged, with a single dollar of equity supporting as much as $100 in debt.

There are at least two kinds of CDOs. The first is the cash variety, which is stocked with bonds or tranches of asset-backed securities. The second is the synthetic kind, which is created by selling protection on the bonds or ABS. How can a CDO be built from credit options? Consider that the seller of protection has the same credit exposure as does the buyer of bonds—in case of a credit event, he is on the hook. The rage to create synthetic CDOs is, on balance, a good thing for the prudent readers of *Grant's*. The booming supply of CDS lowers the cost of protection they buy, or can (and should) buy. Synthetic CDOs are believed to be widely marketed to the trusting financial institutions of Europe and Asia.

In this essay about derivatives, our view is itself partially a derivative. The entity from which it is derived is Pennant Capital Management, a New Jersey long-short equity hedge fund. Alan Fournier, a paid-up subscriber to *Grant's*, is the managing member. Fournier says that Pennant is expressing a bearish view on housing in the CDS market by buying protection on the weaker tranches of at-risk mortgage structures. At the cost of $14.25 million a year, the fund has exposure to $750

**The best of times for housing?**




source: The Bloomberg

million face amount of mortgage debt.

"I come to this as a student of subprime lending and the housing sector," Fournier tells colleague Dan Gertner. "We were actually long the subprime lending stocks until four or five months ago. We have been short the housing stocks since last summer. The dynamics of those two industries are sort of colliding here in what I think will be a very significant home-price decline. That is the backdrop."

As a buyer of protection, Fournier writes checks to the sellers of protection. The prices he's paying are remarkably low, both he and we judge. They range from 190 basis points a year for the so-called better loans to 220 basis points a year for the riskier ones. He keeps writing checks to the sellers unless and until there is a "credit event," an interruption in the payment of principal and interest by the home buyers to the lenders. If and when trouble strikes, it's the sellers of protection who start writing checks to the buyers.

The odds of a credit event heavily depend on the structure of the mortgage security, or tranches of mortgage security, on which one is buying protection. As a rule in an asset-backed deal, principal and interest come in at the top of the credit ladder and cascade down, while losses come in at the bottom of the credit ladder and infiltrate up. At the penthouse are triple-A assets; at the ground floor, triple-B-minus-rated ones; in the basement are the unrated assets, including what is called an "overcollateralization" tranche. "What has happened over the last four or five years," Fournier observes, "is that home prices have been rising so rapidly that not only did you have the shock absorber of overcollateralization in the loan, but you also have the 10% accretion in values of homes per year that created additional equity to create very solid credit performance for these securities historically."

Yet, even in the best of times, subprime mortgages suffered losses of 4% to 5% a year. In what are no longer the best of times, the damage is bound to be greater. Overcollateralization today runs to about 5% per CDO, Fournier says. Is it so hard to imagine losses equal to, or in excess of, 5% in a national housing bear market? Losses over and above the overcollateralization shock absorber would eat first into the lowest-rated investment-grade tranche, i.e., the triple-B-minus layer, which typically accounts for 2% or 3% of assets. They would next undercut the triple-B-rated tranche, which accounts for another 2% or 3% of assets. If the losses kept coming, the higher-rated tranches would follow the lower-rated ones to the mark-to-market chopping block.

But it would require no national catastrophe to deliver outsize returns to the discriminating CDS buyer. The sharp corrections already under way in the boomier real estate markets might suffice to wreak havoc in a geographically concentrated CDO. Fournier says

## House of the 20 tranches

| tranche | initial principal balance | pass-through rate, 1-mo. Libor plus | rating |
|---|---|---|---|
| A-1 | $549,265,000 | 24 bp | Aaa/AAA |
| A-2A | 333,119,000 | 12 | Aaa/AAA |
| A-2B | 135,251,000 | 24 | Aaa/AAA |
| A-2C | 68,780,000 | 38 | Aaa/AAA |
| M-1 | 57,482,000 | 47 | Aa1/AA+ |
| M-2 | 53,171,000 | 49 | Aa2/AA |
| M-3 | 31,615,000 | 51 | Aa3/AA |
| M-4 | 28,023,000 | 60 | A1/AA- |
| M-5 | 25,149,000 | 64 | A2/A+ |
| M-6 | 23,711,000 | 69 | A3/A |
| M-7 | 19,400,000 | 117 | Baa1/A- |
| M-8 | 17,963,000 | 137 | Baa2/BBB+ |
| M-9 | 15,808,000 | 180 | Baa3/BBB |
| M-10 | 12,215,000 | 300 | Ba1/BBB- |
| B-1 | 14,371,000 | 300 | |
| B-2 | 25,149,000 | 300 | |
| B-3 | 15,089,000 | 300 | |
| CE | 11,496,688 | | |
| P | 100 | | |
| R | 0 | | |
| Total | $1,437,057,788 | | |

he invests security by security. He likes "high Florida exposure, high California exposure, high second-lien exposure. You look for equity take-out loans, because those appraisals tend to be overstated, a high percentage of stated-income loans (a.k.a. liars' loans), and you build yourself a portfolio of credits from weak underwriters that are ultimately likely to be impaired.

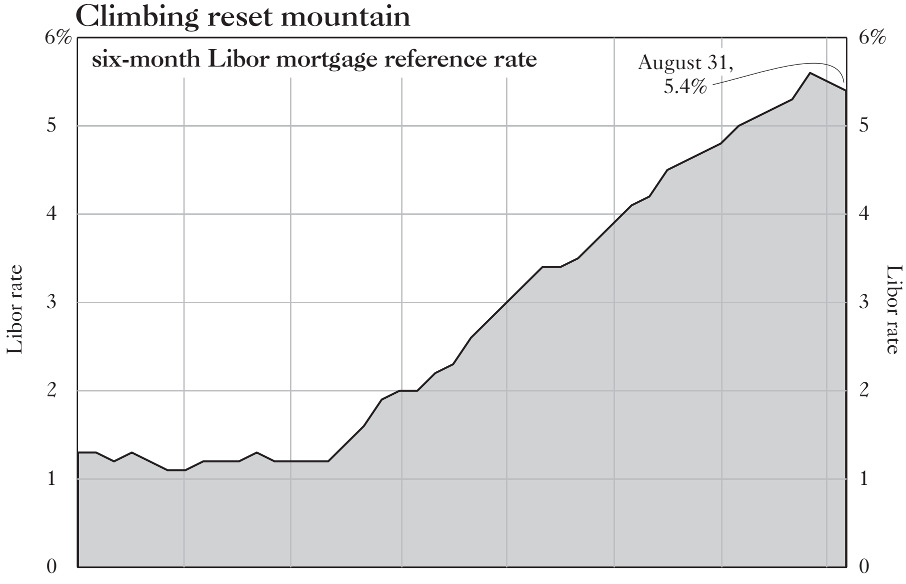
"Most people start with the assumption that house prices don't go down," Fournier goes on. "I think they will. I think if they only went down 2% or 3%, it would be remarkable. This paper has been experiencing 4% to 5% cumulative losses during a home price environment where we've seen 10% annual increases. In theory, if we just went flat, you would see 14% to 15% losses in these same portfolios, all else being equal. All else isn't equal, obviously. We have oil prices up, we have $400 billion of ARMs adjusting up this year, another $1 trillion reset next year, and the whole idea that people will simply refi their way out of trouble is no longer going to be an option. The guys that write this paper—the subprime lenders—view these guys that are having these resets as future business, 'because we will just write them a new loan.' It is not going to work if home prices are not going up, and the fed funds rate is not back to 1%."

Prompted by Fournier, Gertner delved into one of the myriad of mortgage-backed structures on which a professional investor can buy or sell protection (administrative complexities bar the amateur, even a rich and sophisticated one, from doing the same for his or her own account). The ACE Securities Corp. Home Equity Loan Trust, Series 2005-HE5, is the specimen under examination. The trust, which came into the world in August 2005, is no outlier but a fairly standard item of the hundreds of billions of dollars' worth in the market today. It was created from a pool of first and second liens of varying credit characteristics (4,666 of the loans conformed to Freddie Mac loan limits, which earned them the imprimatur, "Group I"; the balance of the loans may or may not so conform and are designated "Group II"). At inception, the trust had a par value of a little more than $1.4 billion; 17.8% of the loans were fixed-rate, the balance adjustable.

Simplicity is not the trust's outstanding design feature. It holds 20 tranches, with the bulk of the dollar value in triple-A loans but—as the diagram points up—tens of millions of dollars in loans in the lower realms of investment-grade and an equity pool in the sum of $11.5 million. These tranches are the cannon fodder of a hypothetical real-estate bear market. Realized losses on the mortgages held in the portfolio would be absorbed, first, by that net monthly excess cash-flow account; second, by the CE certificates (for "credit enhancement"); third, by the class B-3 certificates, and so forth, until housing Armageddon, when not even the A-1 tranche would be left undamaged.

Studying the architecture of this edifice of home equity loans, Gertner notes a striking lack of diversification. At the time of creation, no less than 34.5% of the principal balance of the mortgages was exposed to California, 11% to Florida and 10.4% to New York.

### Climbing reset mountain




source: The Bloomberg

Interest-rate reset dates were bunched in May-June 2007, when more than 90% of the ARMs in the portfolio are expected to be adjusted. Forty-odd percent could be adjusted by two percentage points, while 59% could be adjusted by as many as three percentage points. Subsequently, the loans can be adjusted between one and two percentage points every six months.

"Of course," notes Gertner, "the rate could be adjusted down as well as up, but looking at the reference rate—for the most part, six-month Libor—an upward reset seems much more likely. First payments for the loans in the trusts occurred between September 2004 and August 2005, between which dates six-month Libor climbed to 4.1% from 2.2%. Today, with Libor at 5.4%, a three-percentage-point reset is possible, and a reset of more than one percentage point is probable. Naturally, interest rates could fall by the middle of next year. But a weak economy—if that were the reason for the drop—would add another hurdle to the already obstacle-littered real-estate playing field."

At the time of closing, 29% of the loans were of the interest-only kind (70% had the traditional principal amortization feature and 1% were balloon loans). As to the purpose of the loans, almost half were earmarked for cash-out refinancing. As to documentation, 58% had the works, with most of the balance showing only "stated documentation" (cross your heart, Mr. or Ms. Mortgage Applicant, please, not your fingers).

To date, the trust has given a good account of itself, with not one credit event blackening the record of the first year. In the 13 months since launch, the natural churn of the U.S. housing market has reduced the outstanding principal balance of the trust by $414 million, to $1.023 billion, and the number of loans by 1,935, to 5,277. Because the junior tranches are supporting a lower dollar value of senior debt, effective credit support for the high-rated debt has ratcheted up. All of which is to the good.

But termites are busily gnawing at the mortgage foundations. At last report, which was August's, 8.8% of the principal was delinquent and 4.2% was in foreclosure—$90 million and $43 million, respectively. For perspective, just $66 million of principal buffer stands between the two lowest-rated mezzanine tranches, M-9 and M-10 on the diagram, and some future loss.

Yet, according to Fournier, credit protection on those very two tranches is available for only 220 basis points a year. Is it so hard to envision the circumstances in which delinquencies and foreclosures on the California and Florida segments of the trust's portfolio would move drastically higher? We can hardly imagine circumstances in which they wouldn't.

"What I have done," Fournier tells Gertner, "is put together a portfolio of this stuff. I have $750 million of this stuff shorted. My cost is $1.9% [the previously cited $14.25 million a year]. My return could be $750 million." As risks and rewards go, we judge, not bad.

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## *Over the cliff with Morgan Stanley*

(October 20, 2006) Alone among the Wall Street financial-services providers that used to style themselves, simply, as "brokerage houses," or—with a little more tone—"investment banks," Morgan Stanley is the owner of a $1 trillion balance sheet. It cleared the 10-figure mark on the May 31 statement date. The former white-shoe partnership has expanded its footings at the rate of 21.5% per annum since 2003. It has left Goldman Sachs in the dust, size-wise. And while no lawful, tax-paying, privately operated financial institution in the world can match the Fed's gross margins, Morgan Stanley today deploys more assets than the house of Ben S. Bernanke.

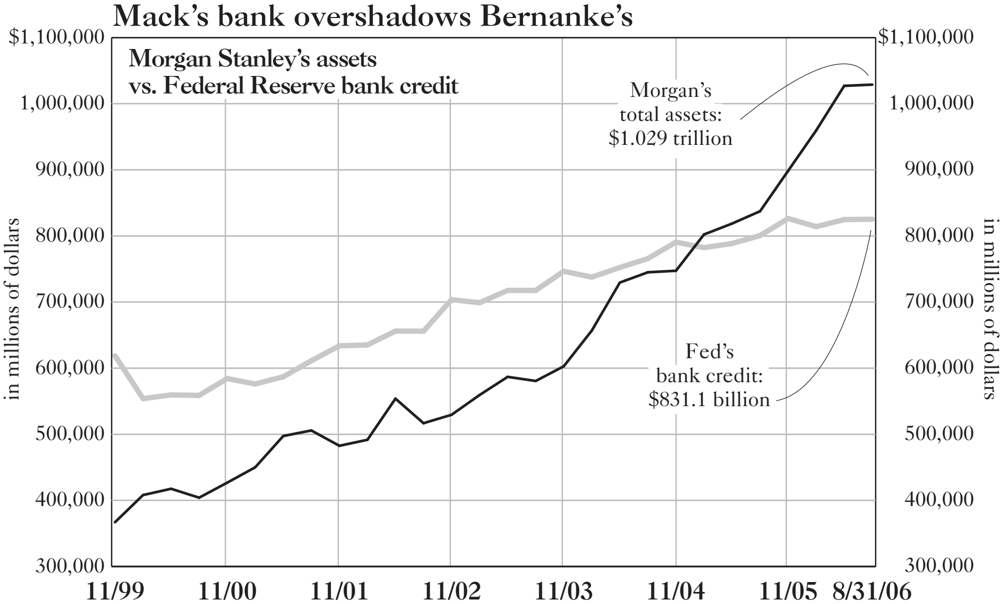
It would be well for Morgan if Bernanke et al. delivered a nice, safe, soft landing in any future macroeconomic descent. Wall Street is heavily exposed to credit risk, and Morgan Stanley is especially heavily exposed. For one thing, Morgan itself is highly leveraged. For another, its corporate clientele is increasingly highly leveraged. And, for a third, its Discover Card customers and mortgage borrowers are—many of them—presumably highly leveraged. Morgan Stanley is, in fact, a dealer in, and user of, financial leverage on a huge and growing scale.

Without reference to price, "risk" is an uninformative word, and the bearish indictment we are about to hand up against Morgan Stanley is not that the firm is shouldering lots of risk. Our complaint is, rather, that the firm and its stockholders are not being properly paid for their trouble. How could they be, given the compression of credit spreads, the flatness of the yield curve, the Street-wide stampede to facilitate private-equity promotions (now under the glare of the Justice Department), the late-cycle relaxation of lending standards and the widely credited myth that the Federal Reserve will pull the market's chestnuts out of the fire before they're even so much as singed? Admittedly, this might seem a hard point to carry in the wake of a quarter in which Morgan's earnings from continuing operations jumped by 61% and its return on equity totaled 23%. We reason, however, that whether or not this is the top of the credit cycle, it certainly isn't the bottom, and to generate the returns it does, Morgan Stanley is traipsing through minefields. In the asymmetry between what it earns and the chances it takes to earn it, Morgan reminds us of the mutual funds that racked up triple-digit profits in the 1990s, only to give them back, with interest, in the 2000s.

No doubt, Morgan Stanley's top managers would think long and hard before jumping off a bridge with a length of elastic rope tied to their ankles or making a dash across Sixth Avenue against the traffic. But John Mack did not return triumphantly to the chief executive's chair in 2005 to err on the side of caution. His remit is to run the ball down the field and into the end zone, "end zone" being an undefined term but perhaps taking the form of a merger with a giant commercial bank. In the wake of its protracted executive-suite soap opera, Morgan is probably the least likely firm on Wall Street to beat a tactical retreat from risk on account of the dangers that a turn in the credit cycle may present on some indeterminate future date (which date this publication expected long before now). The regenerated Morgan Stanley seems determined to make money while the making's good.

We say that the making's not so good as it seems—indeed, that the markets Morgan Stanley is just now getting around to entering would be better candidates for a timely exit. We have in mind, specifically, nonprime residential

**Mack's bank overshadows Bernanke's**




source: The Bloomberg

mortgage lending, which Morgan belatedly entered with its August acquisition of Saxon Capital (a transaction that "provides Morgan Stanley with new origination capabilities in the non-prime market, which we can build upon to provide access to high-quality product flow across all market cycles," the Morgan announcement said in part). And we have in mind private equity, which the firm is reentering after a two-year absence, and hedge funds, a couple of which the firm has been rumored to be scooping up. As for Morgan's acquisition last Friday of Chicago's Downtown Public Parking System, for $563 million, "the first purchase by the bank's infrastructure investment group," as Bloomberg reported, we only note the headline on page 24 of Tuesday's *Financial Times*: "Fingers could get burned as hot money floods infrastructure."

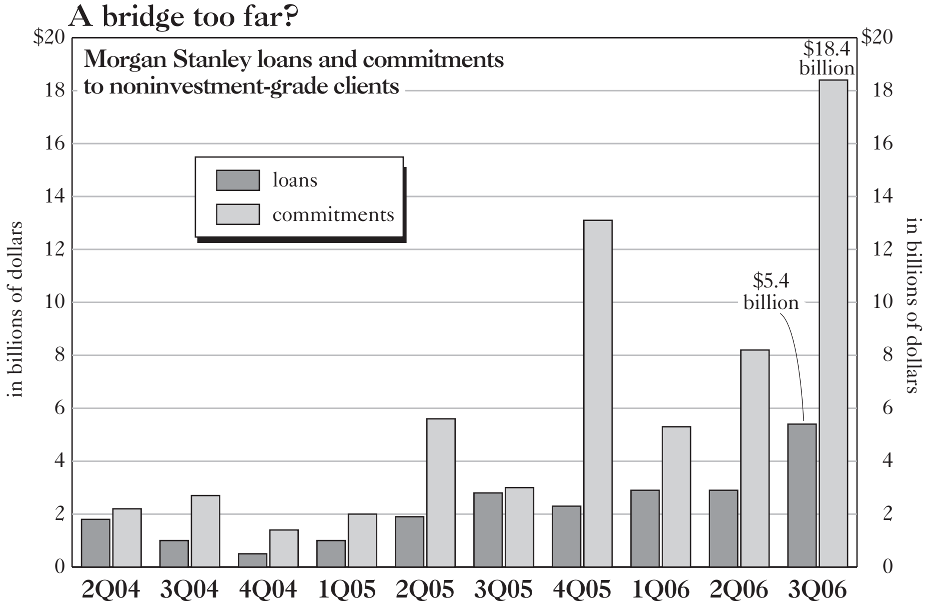
But the business we would fly fastest from, not toward, if we were in the Morgan driver's seat, is the business of making bridge loans to speculative-grade borrowers. Typically, these are companies undergoing a leveraged buyout. The bridge lender extends credit pending the close of the anticipated transaction, at which time the new entity is expected to fund itself in the capital markets. Mack and we seem to disagree on the advisability of jumping in now with both feet. Morgan's commitments to lend leapt by $10.2 billion in the latest quarter alone—to $18.4 billion in August from $8.2 billion in May. And as the firm readily admits, the credit of low-rated companies is difficult or impossible to hedge. "Maybe just help us, how do we think about that risk?" an analyst asked Morgan Stanley's chief financial officer, David Sidwell, on the September conference call. "Because I know it looks a lot more dangerous than it is, and it's actually a great business."

Yes, indeed, Sidwell replied, it *is* a great business. And what makes it great is that Morgan Stanley's niche is origination and distribution. Not if it can help it does Morgan hold a loan beyond the few months it takes for the borrower to secure permanent financing in the junk-bond or the leveraged-loan markets. Morgan not only knows its credits cold, Sidwell went on, but it is also careful to keep its options open. It retains the right to charge a higher interest rate or to back out of the loan altogether if the borrower runs into sudden financial problems. Of course, he added, if the credit markets collapsed, a lender could get caught in spite of these safeguards. It happened in 1989-90.

First Boston then achieved the inglorious distinction of owning more than $1 billion in "hung" bridge loans, a.k.a. bridges to nowhere or, more pithily, "piers." The bridges became piers when the junk market suddenly shut down in the fall of 1989. Bridge-loan promoters noted that most of First Boston's bridge loans, even some of the most speculative, worked out eventually—out of 25, only five went sour. Unfortunately, as with real bridges, an 80% success rate was inadequate. Except for the costly and reluctantly tendered support of its parent, CS Holdings, First Boston could very well have been a goner.

"I think we remember 1989, you remember 1989, and I think a lot of the managements remember 1989," Peter E. Nerby, a Moody'vice president, tells colleague Dan Gertner. "And we think that risk management at securities firms actually works pretty well. So we think a more likely scenario is the market just slows down, the inventory runs off, it gets syndicated. But you're right, there's always a risk that something

**A bridge too far?**




source: company filings

turns quickly. That can happen."

In the debt markets these days, risk seems a cloud no bigger than the size of a man's hand. Through last month, just six high-yield companies had defaulted in 2006, which puts the junk-bond market on the road to the fewest defaults in a quarter-century. At Discover, Morgan Stanley's credit card subsidiary, delinquencies and charge-off rates are near their cyclical lows. But no financial sky is forever blue, and thunderheads are forming in credit—from mortgages to speculative-grade debt to the "structured" bits and pieces of junior debt that trade at 200 basis points over Libor but, come the deluge, will almost certainly trade at 1,000 over. In one corner of its immense corporate skull, Morgan seems to agree. *The Wall Street Journal* reported the other day that the firm is in talks to acquire 20% of Avenue Capital Group, a hedge fund specializing in distressed debt. "Players like Avenue's founder, Marc Lasry, have been amassing war chests in the last few months in anticipation of credit problems among lower-rated companies after several years of easy money," the *Journal* said. "At a recent conference, Mr. Lasry told investors he expects that to come in the next three to nine months."

Morgan Stanley, in fact, has been hiring distressed-debt talent on both sides of the Atlantic. "Deals done in 2006 have been at historically high valuations and leverage multiples, so there is very little room for slippage," Pat Lynch, the head of Morgan's distressed-debt team in Europe was quoted as saying in London's *Daily Telegraph* last month. Lynch went on to venture that the cyclical chasm will not open immediately: "We think it's going to take time through 2007 for the fundamentals to really deteriorate," he said, "but we're ready for business if it does."

Nobody can know. Nor can anybody know which market will blow, come the turn in the cycle. But what we all can and should know is that the post-2002 credit expansion has been one of the all-time least discriminating. Whether in residential mortgages, tradable bank debt, speculative-grade bonds or so-called structured credit, few borrowers have been left behind. It follows that, come the next crack-up, both peril and opportunity will be unsurpassed. Martin Fridson's analysis again comes to mind (see the prior issue of *Grant's*). Given the dodgy ratings mix of current junk-bond issuance, he points out, a recession no more severe than the meek and mild 1990-91 downturn could produce a default rate "not observed since shortly after the bottom of the Great Depression, in 1933."

Whether Morgan Stanley's investment in distressed-debt is a timely hedge or a case of cognitive dissonance is a matter for speculation. On balance, certainly, the firm is hugely exposed to the adverse consequences of the boom from which—now that Mack is back—it's riding for all it's worth. Goldman and, indeed, the rest of Wall Street are riding hard, too. All, for now, are the happy heirs to the low interest rates and tight credit spreads that the Fed helped to instigate in the name of fighting "deflation" back in 2002-03. We pick on Morgan not only because, among all the brokers, it has the biggest balance sheet and, arguably, the most motivated CEO, but also because its bridge-lending disclosure is so forthright. And it is expanding as if—literally—there were no cyclical tomorrow.

Last week, Bloomberg broke the news that, following a two-year absence from the private equity market, Morgan Stanley is making its return with a takeover fund totaling as much as $5 billion. As with hedge funds, bridge lending, infrastructure investment and nonprime residential mortgage origination, Morgan does not exactly have the field to itself. According to Dealogic, in 2005 the private-equity maw absorbed 951 U.S. companies worth $163.3 billion. In only the first nine months of 2006, it has swallowed 813 U.S. companies worth $245.8 billion, more than twice the pace of a year ago.

"At stake is Chief Executive Officer John Mack's mandate to reverse a slide that began under predecessor Philip Purcell and restore Morgan Stanley to the stature of its late 1990s heyday, when it was the envy of the securities industry and earned 75% more than Goldman," Bloomberg said. "The focus on LBOs once again puts the New York-based company in competition with the biggest buyout firms, including the Blackstone Group LP. . . ."

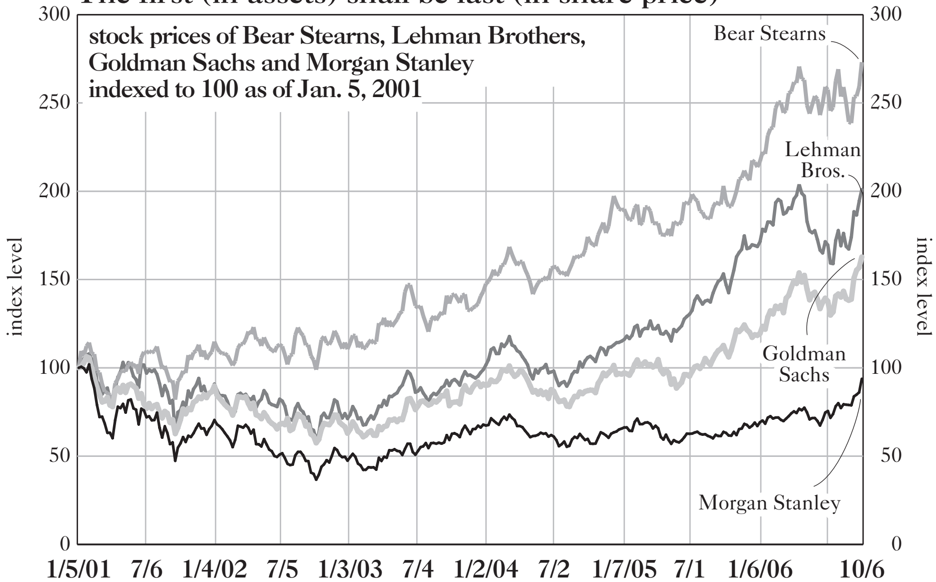
Of all the times not to have to compete with Blackstone, we would put the autumn of 2006 at the top of the list.

## Morgan Stanley vs. the field
### (in $ millions)

| | last 12 mos. to 8/31/06 | 2005 | 2004 | 2003 |
|---|---|---|---|---|
| **Morgan Stanley** | | | | |
| Total assets | $1,028,872 | $898,523 | $747,334 | $602,843 |
| Total debt/total assets | 78.3% | 79.9% | 76.4% | 74.7% |
| Equity/total assets | 3.2 | 3.3 | 3.8 | 4.1 |
| Value at risk (VaR)* | $79 | $85 | $73 | $55 |
| **Goldman Sachs** | | | | |
| Total assets | $798,309 | $706,804 | $531,379 | $403,799 |
| Total debt/total assets | 64.9% | 68.9% | 64.5% | 66.5% |
| Equity/total assets | 3.8 | 3.7 | 4.7 | 5.4 |
| Value at risk (VaR)* | $130 | $99 | $95 | $82 |
| **Bear Stearns** | | | | |
| Total assets | $334,760 | $292,635 | $255,950 | $212,168 |
| Total debt/total assets | 63.7% | 64.9% | 63.2% | 62.3% |
| Equity/total assets | 3.4 | 3.6 | 3.3 | 3.3 |
| Value at risk (VaR) * | $41 | $29 | $22 | $22 |
| **Lehman Brothers** | | | | |
| Total assets | $473,737 | $410,063 | $357,168 | $312,061 |
| Total debt/total assets | 81.5% | 81.7% | 82.3% | 83.5% |
| Equity/total assets | 3.7 | 3.8 | 3.8 | 3.9 |
| Value at risk (VaR)* | $54 | $55 | $38 | $31 |

*minimum loss expected in one out of 100 trading days, as calculated by Fitch
sources: Bloomberg, Fitch Ratings

**The first (in assets) shall be last (in share price)**




source: The Bloomberg

It's not that Stephen Schwarzman, the Blackstone CEO, doesn't sound reasonable. Rhetorically, he's unanswerable. "As the economic cycle lengthens, prices tend to get higher and the prospects for earnings growth tend to get a little weaker, so it's a time where one needs to exercise caution," he told Reuters recently. So much for words. As for deeds, Blackstone is leading the $17.6 billion leveraged acquisition of Freescale Semiconductor, a deal that the great and knowledgeable Fred Hickey, editor of *The High-Tech Strategist*, calls "insane." Hickey and Gertner and your editor are as one on that point. But, crazy or sane, the Freescale transaction is emblematic. It is what passes for good business in 2006. Let us look at the numbers.

If the recent buyout of Philips Semiconductors (now NXP Semiconductors) is any guide, Freescale will be paying an interest rate of 8% on its projected $10.45 billion of debt, implying annual interest charges of $836 million. Yet, between 2001 and 2005, the prospective borrower generated that much EBITDA in only two years, 2004 and 2005. In 2001, the cyclically vulnerable chip maker produced cash flow of all of $22 million, an impressive $814 million less than the projected post-deal interest charge. Naturally, it being the twilight of the private equity feast, Freescale is going to be very highly leveraged. "The ratio of debt to EBITDA is eight times," Gertner points out. "Yet Morgan Stanley is building up its European distressed team to capitalize on the opportunities that leverage ratios of a mere six times are likely to produce."

In defense of the alleged profligacy of the GOP-controlled 51st Congress (1889-91), which its detractors dubbed the "Billion Dollar Congress," Republicans of the day proudly countered, "It's a Billion Dollar Country!" No doubt the overseers of the first trillion-dollar balance sheet in the U.S. stock-brokerage industry reason that these are trillion-dollar markets. So they are, not least in leverage.

After cycles turn, chastened investors look back in amazement at the things they credulously believed. The more introspective reexamine the transactions and news headlines that—as they can see so clearly after the fact—provided the tip-off that markets had gone too far in one direction or the other. Looking back on the upswing of the mid-2000s, posterity may emit low whistles at the news (broken by Bloomberg on October 2) that Morgan Stanley intends to provide its highly paid employees with $2 in margin debt for every $1 of bonus money they contribute to the firm's hedge funds and LBO funds. If the investments earn more than the interest rate charged, the employee must repay the loan, with interest. If the investment is a loser, however, the loan and the loan service are forgiven.

As a compensation and retention scheme, the bruited Morgan Stanley heads-you-win, tails-we-lose idea may or may not secure the loyalty of the firm's rainmakers. And it may or may not be unique on Wall Street (supposedly, other firms also dispense two-to-one nonrecourse margin debt to favored employees). In any case, to us, it's symbolic of the new, exquisitely ill-timed Morgan Stanley push for growth and greatness. We admit that ours is a minority opinion. Gertner's survey of the rating agencies turned up no substantive criticism of the firm or its risk-management procedures. Yes, Morgan's so-called value-at-risk is going up, the analysts say, but so, too, is its equity. As to the profitable (and nontransparent) prime brokerage business, says Fitch, "We believe the number of new entrants into the prime brokerage business is pressuring profit margins for Morgan Stanley but that risk appetite has not materially altered."

For our part, we believe that risk appetite throughout the credit markets is ravenous, and that the proof of just how precariously balanced these markets have become is how few people appear concerned. Spreads on five-year credit-default swaps for the major Wall Street firms (e.g., Morgan, Goldman, Lehman, Bear Stearns, Merrill Lynch) are quoted between 20 and 34 basis points, at or near historical lows.

The non-crisis attending the collapse of Amaranth Advisors last month has further steadied Wall Street's nerves (not that they needed it). If a $6 billion hedge-fund collapse does no systemic damage, what event could? But the tranquilizer dispensers overlook that Amaranth dealt in exchange-cleared markets. Credit is an uncleared, over-the-counter market. No clearinghouse insists on scrupulous daily marks to market, with the appropriate rebalancing of collateral. In credit, it's mark as you please, leverage as you can. Never before have hedge funds taken such an active role as lenders. And in no cycle prior to this one have the terms and conditions of lending been so free and easy across so many markets. Observing these facts, we doubt that anybody's risk models are properly tuned and calibrated.

Thus, Gertner wryly observes, the new Morgan Stanley wins plaudits from the stock market. "It's a great time to expand into the nonprime residential mortgage business—despite the now apparent housing slowdown," he winds up. "It's a great time to re-enter the private equity business—despite the high multiples being paid for previously off-limit industries. It's a great time to expand your hedge-fund business—despite the blowup of Amaranth (in which Morgan happened to get caught). And it's a great time to expand into bridge lending because, to quote one of the rating-agency analysts with whom I spoke, 'These firms are very good at managing these risks.'"

It's a great time, in fact, to buy some disaster protection—puts or, for the institutionally equipped, CDS, on Morgan Stanley (MS on the New York Stock Exchange). Insurance is cheap at the price.

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## *Introducing the Grant's Supermodel Credit Portfolio*

(December 12, 2008) Credit is what we are bullish on—cast-off residential mortgage-backed securities, senior bank loans, convertible bonds and corporate debentures, high-rated and middling. And it's credit that fills the new *Grant's* model portfolio. Expectantly, we call it our Supermodel Portfolio. May it deliver superior returns for 2009 and beyond. No guarantees, of course. However, at the least, we expect it will outearn the corresponding portfolio control group, an assortment of long-dated, "super-safe" (as a certain newspaper habitually calls them) U.S. Treasurys. Whoever coined the phrase "return-free risk" to apply to government securities at these ground-hugging yields was a sage as well as an aphorist. Barring a deflationary collapse, the Treasury market will surely have its comeuppance.

The investments that stock the Supermodel Portfolio have had their comeuppance already. They deserved it. Credit had a heart attack last year on account of its scandalously loose living during the bubble years. Still remorseful and weak as a kitten, the institution of lending and borrowing is gathering strength for the next cycle. A not-bad time to invest, we think.

The portfolio, in the hypothetical sum of $10 million, is apportioned among RMBS, secured bank loans, investment-grade corporates, convertibles and junk (or should we say "high-yield"?) bonds. We set aside no cash reserve. This is not to say, however, that we refuse to entertain the possibility that even better credit opportunities will present themselves in 2009. They well might. If they do, we'll just have to raise some more imaginary millions to scoop them up.

No need to say much on high-yield (see the prior issue of *Grant's*), except to explain its presence in what is intended to be a safe and cheap portfolio. Rarely, if ever, has junk been junkier, to judge by the ratings mix of the bond crop or the likely sky-high prospective default rates. Then, again, we believe, never have yields to maturity been so high—22% on the Merrill Lynch Master II Index. Come the cyclical turn, junk bonds will shine. The question is, from what level will they begin to glimmer? There can be no assurance, to steal a phrase from the junk-bond prospectuses, that it won't be from prices much below even these. The fact is that, at this point in the cycle, junk is hugely speculative. The iShares iBoxx $ High Yield Corporate Bond Fund (HYG on the Big Board), our junk-bond trading vehicle, holds a position in 51 liquid issues. At a price of $64.81, the fund pays monthly dividends to produce a current yield of 13.5%; indicated yield to maturity is 18.7%. Its market cap is $1.02 billion. Given the risks, we assign to high yield an allocation of just 5%. We view it as a portfolio seasoning, an herb.

A little less speculative is the investment-grade component of our Supermodel Portfolio, though investment-grade yields in relation to government yields imply a looming deflationary disaster even for better-rated debt. At 616 basis points, the spread between the Moody's Baa-rated corporate index and the 10-year Treasury is the highest since at least 1962. Indeed, according to Deutsche Bank data recently quoted in these pages, the gap is probably wider than at any point since the Great Depression (when—let us not forget—the nominal GDP was sawed in half). Moody's relates that the investment-grade default rate never topped 1.6% in any Depression year, while the average annual default rate for investment-grade bonds from 1920 to 2006 was just 0.146%; the high was 1.55%, recorded in the recession year 1938. For what it's worth, the Moody's Baa index has actually been rallying these past few weeks, trading to 8.75% from 9.5%, yet such high-quality issuers as Caterpillar and Hewlett-Packard had to dangle 100 basis-point concessions (in relation to the yields assigned to their own outstanding issues) in order to place new securities last week.

Senior loans, in the shape of a $2.5 million allocation to the Nuveen Floating Rate Income Fund (JFR on the Big Board), are the third item in the portfolio. "Leveraged loans" is what the adepts call these instruments. They are secured claims—tradable bank loans—on leveraged companies. True, such leverage was typically excessive, but the senior secured lenders stand to come out of the experience in a relatively strong position. The trouble is that leveraged loans attracted leveraged buyers; they yielded a pittance

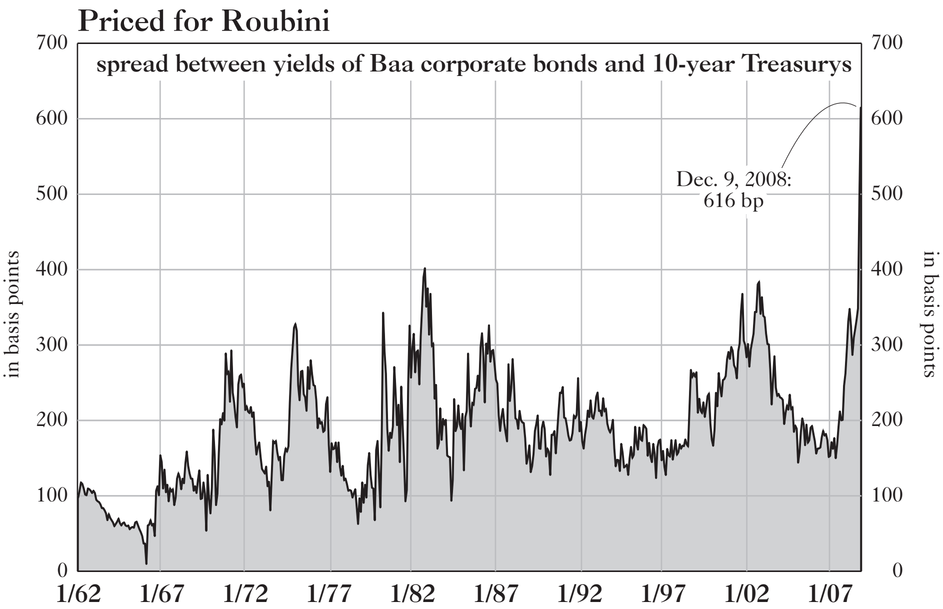
### Treasury portfolio

| security | price | investment |
|---|---|---|
| 4 1/2s of May 2038 | 128-06 | $2.0 million |
| 4 3/8s of February 2038 | 125-03 | 2.0 |
| 5s of May 2037 | 135-15 | 2.0 |
| 4 3/4s of February 2037 | 130-08 | 2.0 |
| 4 1/2s of May 2036 | 123-27 | 2.0 |
| Cash* | | 0.0 |
| Total | | $10.0 |

### *Grant's* Supermodel Credit Portfolio

| | | |
|---|---|---|
| iShares iBoxx $ High Yield (HYG) | 63.75 | $ 0.5 |
| iShares iBoxx $ Investment Grade (LQD) | 92.14 | 2.0 |
| Nuveen Floating Rate Income Fund (JFR) | 5.03 | 2.5 |
| Calamos Convertible Fund, Class B (CALBX) | 15.69 | 2.5 |
| GSAA 2005-12, Class AF-3 | 50 | 1.25 |
| Popular 2007-A, Class A-3 | 32 | 1.25 |
| Cash * | | 0.0 |
| Total | | $10.0 million |

*cash earns 1%.



source: The Bloomberg

over Libor. To enhance the return, loan investors—e.g., hedge funds and collateralized loan obligations—borrowed liberally against the leveraged collateral. Come the great margin call, they sold (and continue to sell) just as liberally. "All told," according to the definitive chronicler of the loan market, Standard & Poor's LCD, "the [loan] index is down 25.5% over the past three months, leaving returns for the first 11 months of the year at a soul-destroying negative 27%, all but ensuring that 2008 will produce the first annual loss for the index, which dates to 1997."

"Soul-destroying"? An editing error, probably; LCD must have meant "wealth-destroying" and, therefore, "opportunity-creating," though the opportunity thereby created seems not yet to be widely perceived. Supply keeps coming out of the woodwork, and the public continues to yank its money from loan mutual funds. Motivated sellers put out calls for bids, i.e., "bids wanted in competition," and they are the bane of the market. BWICs in the sum of $3.3 billion set a monthly record in October. Another $1.3 billion of BWICs rattled the market in November. (These days, OWICs, i.e., "offerings wanted in competition," are only a dim, gauzy memory.) "While these figures are tiny in relationship to the institutional loan universe of $595 billion," LCD observes, "they are daunting in the absence of any new funding sources." Loan funds have suffered net outflows in 16 of the past 17 weeks, for a year-to-date total of $4.5 billion. Assets under management have dropped to $7.5 billion from $15.9 billion.

There are, according to the *Barron's* Weekly Closed-End Funds roundup, 19 loan-participation funds. As you know, closed-end funds issue a fixed number of shares, and with the proceeds from the sale of those shares, they acquire assets. The funds are exchange-listed and the prices at which they trade may or may not mirror the value of the underlying assets. The universe of listed loan-participation funds trades at a large discount to NAV—at last report, an average of 17.2%.

"Investors are getting a double discount," colleague Dan Gertner points out. "The price of the loans held in the portfolios has fallen below par value. And the funds are selling at a discount to the underlying NAV because so many investors are selling. Elliot Herskowitz, president of ReGen Capital, has studied the discounts at which the closed-end funds are trading. He finds that the funds are trading between 30 and 60 cents on the dollar of the underlying par value of the loans. Herskowitz told me, 'It really points out that, based on the way these things are trading, you can buy into loans at 50 cents on the dollar—I mean the senior loans. And I think it's just an unbelievable opportunity out there.' Herskowitz cautions that the market is thin and prices can move erratically. 'But if you're careful about getting in or out, it's just an unbelievable opportunity. It is very rare for the retail investor to actually get a better deal than that which exists for the institutional clients,' he says. 'But in this particular area, at this particular time, given the way these things are trading, it's just a glaring example.'"

We chose the Nuveen Floating Rate Income Fund to carry the leveraged-loan flag for a number of reasons. For one thing, JFR has redeemed 59% of its auction-rate preferred securities ($235 million out of $400 million), and Nuveen says it intends to redeem the balance. For another, 93.6% of the fund's portfolio is allocated to variable-rate loans and short-term investments (many funds have heavy junk-bond exposures). Finally, the fund is quoted at a discount to a discount. Thus, as of July 31, the portfolio encompassed $954 million of loans and bonds. Assuming no change since the reporting date, the underlying assets are trading at 47 cents on the dollar, based on the decline in the disclosed NAV. Then, too, at the current price of $5.03 a share, the fund is trading at an 18.7% discount to its $6.19 NAV. Multiply one discount by the other, and a new JFR investor winds up owning the assets at 38 cents on the dollar. The fund shows these characteristics of diversification by industry: media, 18%; hotels, restaurants and leisure, 7.3%; health care, 6.4%; and chemicals, 4.8%. Typically for the group, JFR is leveraged 42%, with preferred stock and borrowings. The current yield is 14%. In order for JFR to pay a common dividend, the value of its assets must be 200% greater than the value of the leverage-providing preferred stock and borrowings. As of November 28, the ratio stood at 239%, compared—for reference—to 243% in January. (Consult www.etfconnect.com for current information on closed-end funds.) Open-end funds provide unleveraged access to the bank loan market. Among three of the largest are Fidelity Floating Rate High Income, Eaton Vance Floating-Rate Fund and Franklin Floating Rate Daily Access Fund.

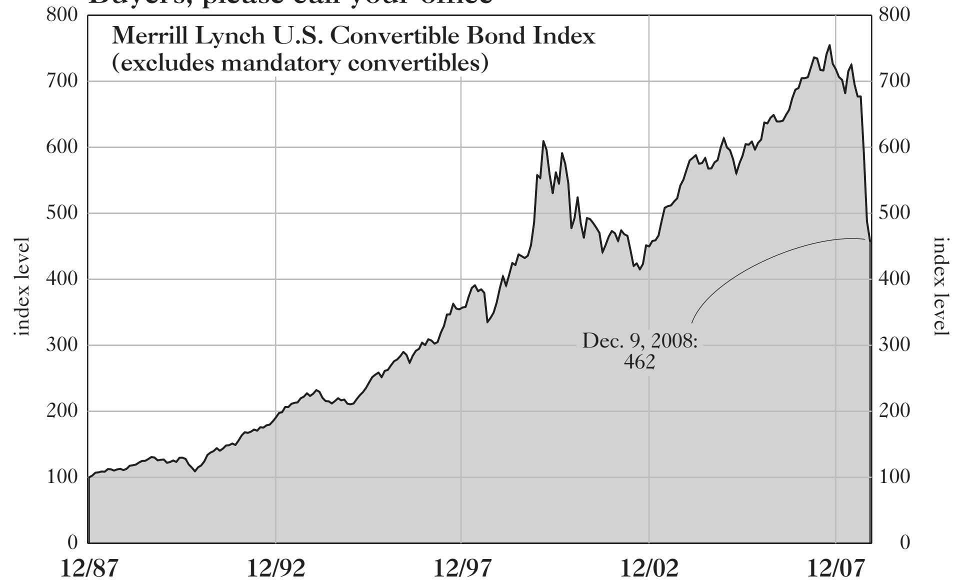
As to convertibles, we laid out the story line in the previous issue of *Grant's*; suffice it to say that they are still not the fixed-income market's favorite flavor. We choose the Class B shares of the open-end Calamos Convertible Bond Fund (CALBX) for the Supermodel Portfolio. The B stock has a deferred sales charge that shrinks by a percentage point in every year that an investor chooses not to redeem—from 5% in year one to zero percent in year six. The fund's annual operating expenses are 1.88%, and the average credit quality is triple-B. Assets total $462 million. Information technology is the top sector weighting (24.4%), followed by health care (20.3%) and consumer discretionary (13.2%). The Calamos fund, founded in 1985, had been closed to new investors since April 2003. It reopened on October 7, with John P. Calamos Sr., co-chief investment officer, recalling the persistent knocking on its door by some would-be investors. "[O]ur response has always been 'not until we identify a significant opportunity that may be advantageous for both new and existing investors,'" he said. "Well, we think we have found one." Nick P. Calamos, co-CIO, added, "According to our research, we believe the global convertible market is significantly undervalued today." So do we.

Last but not least come residential mortgage-backed securities, the hardest of the credit markets' hard cases. In particular, we tap for inclusion in the Supermodel Portfolio a pair of structures we first reviewed in our September 19 issue. They are the GSAA Home Equity Trust 2005-12 and the Popular ABS Mortgage Pass-Through Trust 2007-A. At the time, the slices on which we particularly focused—Class AF-3 of GSAA and Class A-3 of Popular—traded at 69 and 59, respectively. Today's prices are 50 and 32.

At inception, the GSAA Home Equity Trust was stocked with Alt-A residential mortgages, 2,919 of them. All were fixed-rate and first-lien and all had maturities of 30 years or less. The average FICO score, LTV and loan size were 690, 79.1% and $194,740, respectively. Thirty-nine percent of the dollar value of the mortgages was secured by houses in California, Florida and New York.

Oddly enough, the deal hasn't performed badly. The principal balance has been reduced by 43% and the number of loans by 39%. Troubled loans (60 days or more delinquent) stand at 13.8% of the outstanding balance, and cumulative losses amount to just 0.85% of the original balance. We thought that the Class AF-3 was cheap at 69. We like it more—exactly 28% more—at 50. AF-3 pays a fixed coupon of 5.07%, and its credit enhancement has grown to 12.3% from 7.4% as the top of the

**Buyers, please call your office**




source: The Bloomberg

structure has melted away. It is the third-pay bond, i.e., third in line to receive principal payments. But it might as well be second, because the first bond in the structure has paid down 95.8% of its original balance.

In our post-Labor Day review of the RMBS field, Gertner spoke to Bryan Whalen, managing director of Metropolitan West Asset Management. Whalen obligingly came to the phone again last week. He told Gertner that, in a base case, the AF-3 bond would yield 29% to a five-year maturity. Even a modified Nouriel Roubini disaster scenario would permit a 14% yield, he said. In such a setting, the conditional (i.e., steady-state) prepayment rate would slow to 3% from the current 8.2%, 84% of the remaining pool would default (compared to 13.8% of the deal that is currently troubled) and loss severities would reach 70% (up from 50% at present, which is ghastly enough).

And if interest rates should happen to rise, what then? Not much, probably. At 50 cents on the dollar, the AF-3 is trading on credit quality and liquidity, not on interest rates. "I have a hard time believing that this bond would sell off even with a few hundred-basis-point Treasury sell-off," Whalen told Gertner. "In fact, prices may go up in that scenario if the market is indicating that credit is improving and the economy may be improving and reinflating."

Our final investment, the Popular ABS Mortgage Pass-Through Trust, will absorb our last imaginary $1.25 million. Your hand may quaver when you write the check (if you are following along at home), as the Popular bond—triple-A-rated Class A-3—houses subprime mortgages. The wrinkle is that the mortgages are overachieving ones, though priced as if they were slugs. For one thing, adjustable-rate loans constitute just 49% of the 2,779 mortgages in the pool, the rest being fixed-rate. Usually, ARMs occupy a much bigger share of a subprime RMBS. For another thing, the collateral is widely distributed, with just one bubble market—Florida—in the top five.

On the face of it, our Popular investment will win no quality-assurance awards. Its troubled loans stand at 21.6% of the outstanding balance, while cumulative losses total 1.5% of the original balance. But it shines in comparison to an especially rotten field. In the 07-2 portion of the tradable ABX subprime mortgage index, for instance, troubled loans amount to 35.7% of the outstanding balance, while cumulative losses foot to 4.9%. That ABX subindex last traded at 33.6, a slight premium to the plainly superior Popular bond.

Though the Popular deal references slightly more fixed-rate mortgages than it does ARMs, the Class A-3 bond pays a floating-rate coupon: Libor plus 31 basis points. That fact, of course, makes it more sensitive to interest-rate movements than the preceding AF-3 model, but only to a degree. At 32 cents on the dollar, the market is plainly more worried about solvency than about Libor.

Whalen's base case would produce a yield to maturity of 21% and an average life of eight years. The stress case—a 3% prepayment vs. an observed 14.7% rate, and 93% of the remaining loans defaulting with a loss severity of 70%—still results in a 14% yield to maturity.

"The mark to market over the past couple of months has been brutal," Whalen tells Gertner, "but if you can put the emotions aside and keep your eyes on the horizon, and not on short-term volatility, investors should be drooling over today's prices."

Pass the napkins and reach for the "buy" tickets. May the *Grant's* Supermodel Credit Portfolio be worthy of its name.

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## *Options on recovery*

(March 6, 2009) As to whether the world will survive, opinion is mixed. Some say yes and some say no, and others are on the fence. Neither is there any firm consensus concerning the nation's banks. Will even one remain in the private economy on the day the Great Recession expires? You can get an argument.

Now unfolding is an exploration into the crisis-related investment opportunity. We write, we hope, with a due sense of the gravity of the times. It's not just every cycle in which a certain Ayn Rand disciple and former Fed chairman plumps for nationalizing American banks. Then again, the bad news is not exactly news anymore. From its peak, the Keefe, Bruyette & Woods bank-stock index (BKX) has fallen by 82%, while the financial-stock component of the Standard & Poor's 500 Index weighs in at just 9.5% these days, down from 22.3% as recently as September 2006.

Yet, your editor is here to attest, if there is anything scarier than owning the stocks of banks, brokers and insurance companies during a credit liquidation, it's being short them during the post-crisis moon shot. Citi, for example, was an $8.50 stock in December 1991. Within two years, it was a $40 stock. Within six years, it was earning—almost—its intraday-low 1991 share price. The Bank of New Hampshire traded at $3.50 a share in September 1991, two weeks before the FDIC seized seven other Granite State institutions. In April 1996, it fetched $43.50.

Maybe today's basket cases will produce per-share earnings equal to today's share prices at some not-too-distant date. We don't rule it out. Neither do we dismiss the possibility that Sheila Bair will wind up controlling every bank in the BKX. But, born optimists, we attach a higher probability to the former outcome than we do to the latter.

"High expenses for loan-loss provisions, sizable losses in trading accounts and large writedowns of goodwill and other assets all contributed to the industry's net loss," noted the FDIC in reporting that, in the final three months of 2008, insured financial institutions suffered their first quarterly loss since 1990. No surprise, then, that, despite the highest ratio of reserves to loans in 14 years, coverage ratios stand at 16-year lows, or that nonperforming loans climbed by 107% last year to reach 2.93% of overall loans, the highest in 17 years. Also came the report that the top-secret FDIC list of "problem" banks comprised 252 institutions controlling $159 billion of assets, compared to the year-earlier tally of 76 institutions controlling $22 billion of assets. Evidently, Citi is beyond problematical; it alone controls $1.9 trillion of assets. So what is the bullish-bearish-hopeful-confused investor to do?

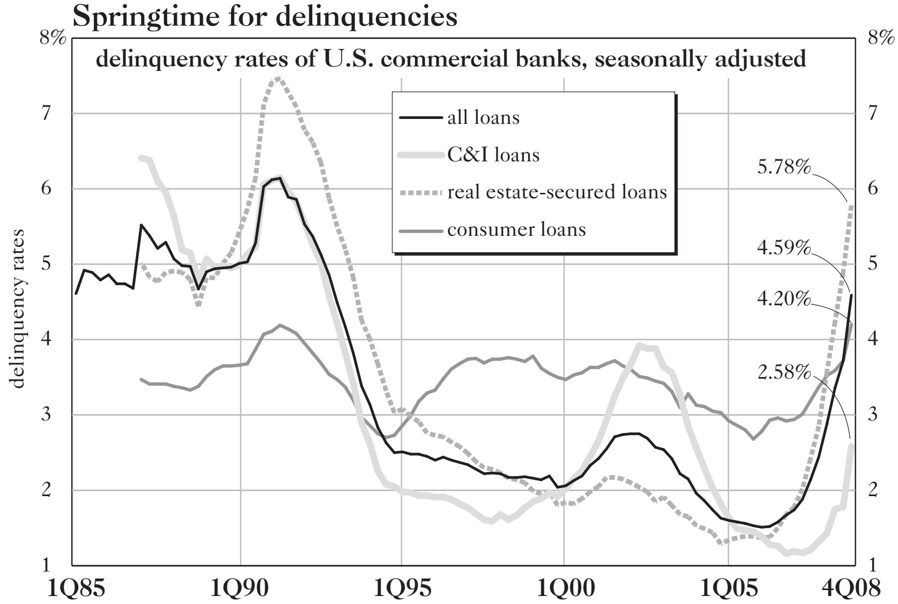
An options strategy, perhaps. Pick an assortment of banks of varying degrees of survivability. Buy call options at strike prices double the current price, with maturities clustered in early to mid-2011. The reason not to do any such thing is that options tick like time bombs. The reason to stop one's ears to the ticking is the likelihood that the cycle will turn within 24 months and financial stocks will lead the way up, with the book-entry share certificates themselves crying hallelujah as they go.

Clairvoyants, seeing into the future, naturally do their bank-stock investing at the bottom. Fearless because they are all-knowing, they buy the juniormost security of the shakiest survivors, the stocks that go up the fastest and farthest. For the rest of us, lacking perfect foresight, we might consider options on the shares of a cross-section of financials, three or so, let us say, from each of the three departments of the financial triage ward: ambulatory, salvageable and doubtful.

BB&T Corp. (BBT on the Big Board) fills the bill of a Ward 1 candidate. The 12th-largest financial-services holding company, Winston-Salem-based BB&T conducts a diversified business—brokerage, capital markets and insurance, besides basic banking—in the American southeast, including formerly bubbly Florida. Nonperforming loans, at 1.34% of total assets, are, so far, manageable, though $8 billion of home builders' loans ("residential acquisition, development and construction loans") and $11.5 billion in commercial real-estate loans may yet break out in hives.

BB&T performed the astounding trick of turning a fourth-quarter and

**Springtime for delinquencies**



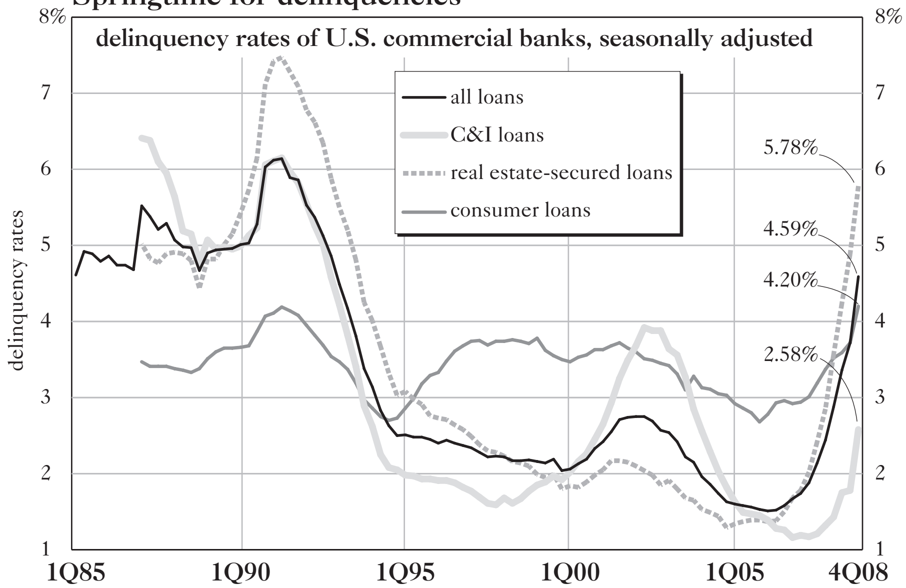

source: Federal Reserve

full-year 2008 profit (of 51 cents and $2.71 cents per share, respectively). It lent more in the fourth quarter than it did in the third, and more in 2008 than it did in 2007. Net cash interest margins fattened by two basis points in the fourth quarter compared to the third, and by 22 basis points compared to the fourth quarter of 2007. Net interest income, before provisions for bad debts, jumped by 7.5% from the 2007 fourth quarter. BB&T did issue $3.1 billion of preferred stock to the U.S. Treasury toward the end of last year in connection with the TARP, but it seems that it didn't have to. With $8 billion of tangible common equity against $152 billion in assets, the bank is sitting in the capitalization catbird's seat—barring, of course, another year or two worth of seismic jolts in credit and business activity.

But, one must consider, what about the other possibility? How would it be for BB&T if all this World War II-grade fiscal stimulus and Weimar-caliber credit creation "succeeded"? Even as it is, according to CEO Kelly S. King, speaking on the fourth-quarter conference call, the market is coming BB&T's way. Customers have come knocking, for one thing. They seem to like a solvent bank. "[I]f you see something that says they can't get a loan, give them my number," King invited the listeners-in.

Then, too, King went on, the collapse of the shadow banking system has done a world of good. "I'm very, very pleased with what is going on with regard to restoring pricing discipline," the CEO stated. "We had an interesting thing for the last 20, 25 years. We disintermediated the banking industry as a huge amount of loans left the banking system and went through securitization into various conduits and other investment areas, which caused two things to happen. One is we lost the volume and put enormous pricing pressure on loans, because a lot of these investors didn't have the capital and reserve requirements that we do. And so I started making loans 36 years ago, and over that period of time, we've lost about 300 basis points on the same kind of loans. We haven't gotten it all back yet. It will take a little while, but on the larger-size credits, we've already seen a 100-plus basis-point improvement just in the last three or four months. We're beginning to install floors on credits because absolute rates are so low, and there is a lot of receptivity to that in the market."

**Springtime for delinquencies**




source: Federal Reserve

PNC, too, is the kind of bank to which nervous, safety-seeking customers have been flying—transaction deposits climbed by $5.9 billion, or 10%, in the fourth quarter—and we place it, side by side with BB&T, in the first department of the *Grant's* triage clinic. On the February earnings call, James E. Rohr, PNC's chairman and CEO, sounded as cheerful as Barack Obama used to before he took office. "We've been open for business throughout this period by adhering to our business model and leveraging our success at building long-term relationships with our clients, and by allocating capital based upon risk-adjusted returns, we've delivered significant value to the shareholders over time."

So far as the dividend is concerned, there will be 85% less of it, PNC disclosed on Monday, suggesting it was the regulators' idea. Up til then, the Pittsburgh-based super-regional had been on the offensive. At the end of December, it doubled its customer base by swallowing Cleveland's National City Bank for $5.6 billion of stock and an odd lot of cash. The combined entity shows $291 billion in assets, $175 billion in loans and $193 billion in deposits. It has a 33% ownership stake in BlackRock, a capital-markets business and a custody business. Nonperformers stand at 74 basis points of total assets, and the allowance for bad loans covers 236% of known duds. National City was choking on bad loans, home-equity credits among others, and PNC was able to mark some of these assets as low as 42 cents on the dollar.

Come the turn, shareholders will thank CEO Rohr for his courage and foresight in buying low. Pending that happy event, however, they will have to live with the possibility that Rohr did not, in fact, buy low, but rather, like so many others on Wall Street, mistook a calamity for a business cycle. As the regulators count capital, PNC is amply covered, with a so-called Tier 1 ratio of capital (equity and preferred) to assets of 9.7%. But the market puts no more stock in the bank regulators these days than it does in the ratings agencies, and the market is focused on tangible common equity. Preferred doesn't count. "Owing to the National City acquisition," colleague Ian McCulley observes, "PNC has a tangible common equity ratio of just 2.9%. Asked on last month's call if another capital raise is in the offing, management was noncommittal. (PNC is one of the few banks that could raise private capital.)" Rohr reaffirmed at a conference on Tuesday that there is no plan to raise common equity.

The *Grant's* triage ward sorts its patients by price-to-book ratios. Goldman Sachs (GS) and Morgan Stanley (MS), unloved though they may be in Washington, D.C., are welcome here, in Ward 2, the salvageables, reserved for shares quoted at a discount, though

## Option basket
### (in $ billions)

| | ticker | mkt. cap | total assets | 5-yr. comp. asset growth | non-perf. to total assets | allw. for loan losses to nonperf. loans | tgbl. comm. equity-to-assets | price to tgbl. book value |
|---|---|---|---|---|---|---|---|---|
| PNC Financial | PNC | $10.6 | $291 | 33.67% | 0.74% | 236% | 2.90% | 1.23x |
| BB&T Corp. | BBT | 8.6 | 152 | 10.94 | 1.34 | 110 | 5.30 | 1.07 |
| Goldman Sachs | GS | 41.6 | 885 | 16.99 | NA | NA | 4.82 | 0.97 |
| Morgan Stanley | MS | 19.5 | 659 | 1.80 | NA | NA | 4.33 | 0.68 |
| Key Bank | KEY | 3.2 | 104 | 4.24 | 1.41 | 147 | 5.95 | 0.52 |
| Comerica | CMA | 2.1 | 68 | 5.11 | 1.46 | 84 | 7.21 | 0.43 |
| Regions Financial | RF | 2.4 | 146 | 24.66 | 1.18 | 141 | 5.23 | 0.33 |

source: company filings

not a gaping one, to book. The Fed's openhanded lending has quieted fears about the pair's liquidity, and disaster has thinned out the competition. In 2008, each shed some of the excess pounds accumulated during the bubble years. Morgan Stanley, for instance, shrank its balance sheet by 37%, to $659 billion. True, for the time being, neither will be raking in billions from highly leveraged proprietary trading. But wider spreads will allow for profitable dealing even on lower leverage. Though the equity advisory business is likely to be as quiet this year as a 2009 off-site, there's work to be had in restructuring and debt underwriting—and in asset management. In the 12 months to November 30, Goldman's asset-management business, which includes prime brokerage, generated $3 billion in pretax earnings on period-end assets of $779 billion, down just 10%. Morgan Stanley's asset arm performed no such feat, showing a $1.8 billion pretax loss after write-downs. The wealth-management business did generate $1.2 billion in pretax earnings, however, and the Morgan Stanley-Smith Barney merger holds promise for the next up cycle. Before it took Smith Barney off the trembling hands of Citigroup, Morgan had 8,400 brokers superintending $546 billion in client assets. Bigger now than Bank of America, which famously bought Merrill Lynch, the new Morgan Stanley will field 20,000 brokers overseeing $1.7 trillion in client assets.

So much for Ward 2. We now come to the institutions about which Mr. Market entertains a reasonable doubt. The likes of Comerica (CMA), Key Bank (KEY) and Regions Financial (RF), among many others, trade at steep discounts to book. They are officially doubtful. Yet, despite their well-aired troubles, each shows a relatively high amount of tangible equity and reserves in relation to nonperforming loans. A word about Regions: With its shrinking net interest income, its immense 2008 net loss ($5.8 billion, owing to a $6 billion write-down of goodwill) and its heavy exposure to residential real estate and construction loans in Georgia and Florida, the bank would appear to have what the early Americans called a churchyard cough. But the insiders, or some of them, seem deaf to it. Over the past six months, they have bought 227,000 shares and sold none.

A glance at the balance sheet conveys no sense of the depth of the bank's admitted problems. Assets foot to $146 billion and shareholders' equity to $16.8 billion, of which $7.3 billion is tangible. Nonperforming assets account for 1.2% of total assets, and loan-loss reserves represent 141% of nonperforming loans. However, on the January call, management warned that 9% of the loan portfolio was "distressed." Residential home-builder loans amount to $4.4 billion, home-equity loans to $16.1 billion and a portfolio of third-party-originated consumer loans (RVs, autos, boats) to $3.9 billion. Management has been more aggressive than most at charging off bad loans, and nonperforming assets actually ticked lower in the fourth quarter.

Then, again, the loan book would be worth $15 billion less than the value at which it is carried if it were marked to market, the recently filed 10-K report discloses. True, under U.S. generally accepted accounting principles, the loan book is not marked to market, but the common stock is. On Tuesday, it was quoted at a ratio to tangible book value of just 0.33%. It seems fair to conclude that good news is not exactly built in.

Alternatively, rather than buying calls on a self-selected basket of potential crisis survivors, McCulley points out, one could use the Financial Select Sector SPDR Fund (XLF). "You can buy call options that expire in January 2011 with a strike of $15 for 65 cents a piece," he winds up. "XLF was last quoted at $7, and come the turn, the sector could easily double. It's happened before."

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## *The thrifts are coming! The thrifts are coming!*

(October 29, 2010) It's no state secret, though it might as well be, that mutual savings banks and credit unions are converting to stock ownership by the score. Distracted by the mega-banks and their mega-fouled-up foreclosure procedures, Wall Street is paying no attention to the associated investment opportunities. Not so *Grant's*: Count us intrigued.

"What we're seeing now is almost too good to be true," Joseph Stilwell, eponymous general partner of Stilwell Partners, advises his limiteds. "Clean, overcapitalized thrifts, with less competition than they've faced in years, are coming public at less than one-half of their value to private buyers. And they seem to be coming en masse."

Stilwell, who has invested in demutualization strategies for more than 20 years, does not exaggerate. Newly converted thrifts are coming to market at discounts of up to 40% and 50% from tangible book value. For the most part, these are unsophisticated institutions. In their innocence, they lent against the collateral of single-family residences on conservative terms and retained the loans on their balance sheets. Not knowing any better, they stood aloof from the securitization frenzy. As a further sign of their ignorance of 21st-century financial practices, they have suffered only modest levels of nonperforming assets. Their managements never got rich—they never gave themselves the chance.

Formal ownership of mutual savings banks and credit unions resides with the depositors (that of mutual life insurance companies with the policy holders). Practical ownership attaches to the sometimes self-perpetuating managements. In any case, mutual institutions exist not to turn a profit but to serve a supposedly broader interest. Following conversion to investor ownership, managements have their chance to maximize revenue, minimize costs and make a little money for themselves. They seem eager for the opportunity.

Of all things, the imminent shuttering of the Office of Thrift Supervision is one of the motive forces behind the charter conversion drive. OTS-regulated thrifts will find themselves under the wing of the Office of the Comptroller of the Currency next summer, in keeping with the provisions of the Dodd-Frank Act. Better the sleepy devil you know than the possibly energetic devil you don't, the converting thrift managements seem to be reasoning. So they're seizing the opportunity of regulatory realignment to convert to stock ownership under the rules before they change, or may change, in 2011.

Perhaps 20 mutual thrifts are in the wings waiting to issue public equity, Stilwell says, and another 30 might be queued up behind them. Mutuals first offer stock to their depositors. Others get their chance to buy whatever shares the depositors decline. In the day, the depositors clamored for every share. These days, there's lots of stock for everyone. Thus, for instance, a clean and overcapitalized Capitol Federal Financial, of Topeka, Kan. (CFFN on the Nasdaq), sold 14.3 million shares in the community-offering phase of its recent conversion and another 6.8 million shares to its employee stock ownership plan. The local interests having had their fill, the company is offering between 118 million and 160 million to the public in a syndicated offering run by Sandler O'Neill & Partners, L.P. For monthly updates on the thrift conversion calendar, consult SNL ThriftInvestor ($495 a year through SNL Financial).

Value-seeking investors will applaud the timing of these initiatives. Conversions are appraised with reference to quoted banks, which have been in a four-year bear market. The Russell 2000 Value Banks Outside New York City Index, for instance, is down 59% from its peak. The component parts of such swooping averages are the small public banks that fell for the high-margin bait of commercial real estate lending. Note, Stilwell observes, the mutuals are mainly innocent of the public banks' sins. Slow and steady won the race.

Many are the drawing cards of the 2010-11 thrift-conversion wave. Not the least is that you, the outside public minority shareholder, invest side by side with the insiders. Everyone gets the same price. "It is not like the usual situation where insiders are selling and trying to get a higher price," says Stilwell. "Here, they are buying with you. And they are also moving the mechanics of the process to get the best price."

There can be no mistaking the run-of-the-mill thrift for Apple Inc. Single-digit returns on equity are the norm, while returns on assets usually fall short of 1%. In management, mediocrity is the standard. In sub-mediocre cases, the president has inherited the bank as he or she might have done the family silver. In the best cases, says Stilwell, the CEO is a decent manager who now, for the first time, has the opportunity to show his or her inner capitalist.

To manage a financial institution in a zero interest-rate world is no cakewalk. Then, again, Stilwell remarks, "You are buying something at less than half of its private market value. . . . You could argue that things do get cheaper at the bottom of the cycle, which is nowhere near, apparently, it seems to me. But what do they go down to? One-third [of tangible book value]? At the same time, they are going to keep growing value. Most of their competitors have been wiped off the map. The world is changing. These are the politically favored entities right now—small community banks. People hate Wall Street. People hate Bank of America. Nobody hates First Federal Savings & Loan of Wichita. So you are likely to see things relatively more favorable for these folks than for the banking industry in general."

A mutual thrift is a latent little bank, Stilwell goes on. The transition to bank from thrift is what many a mutual management hopes for, and works toward. They find it's a long, hard road. "Along the way," says Stilwell, "for one reason or another, say within three to five years—that's our rule of thumb—half of the thrifts that have come public through mutual-to-stock conversion will sell themselves to somebody else. They can't do it, they're tired, they need a lot of fancy systems and the big brother catty-corner to them on the street can do it better, and why not join forces? Half of them are gone, usually at a decent profit, depending on when you first invested in them, within three to five years."

Of course, some will be gone to the happy hunting ground, the consequence of poorly executed expansion plans. Stilwell says he's all for growth, but only the wholesome kind. "If you grow real fast, that is not a great way," he says. "If you spend on acquisitions, that is a pretty bad way. But if you—over two, three, four, five years—take your share count down so that you are then properly capitalized, you've increased your book value, and you've increased your franchise value per share. That's brilliance. And if, at the same time. . .you're cutting your costs and becoming more efficient, and the parking lot doesn't empty out at 4:59 p.m. every day, you have a chance to be a decent community bank, which, historically, is a 12% to 15% return on equity, which any sensible bank investor was thrilled with. Because that is sustainable; they're not reaching, they're not going crazy."

A purely passive investment is one way to proceed. Stilwell, however, prefers to accumulate a greater-than-5% investment and, with the authority a filing position imbues, exercise "adult supervision." "I just filed on two in western Pennsylvania that recently converted," he continues: "First Federal Savings & Loan (FFCO, of Monessan, Pa.) and Standard Bank (STND, of Murrysville, Pa.). Both are little thrifts. I've bought 7% or 8% positions in them, and we've filed 13Ds. They are both cheap. One has a book value of 18ish and the other has a book value of 19ish. We paid 11 and change. They both have earnings. They both have capital—in equity-to-assets after the deal of 15% or so. And they both have nonperformers sub 1%. They are thrifts, banks in potential. We've gone out and met with both of them. They both seem like decent folks. We've told them what we expect: 'That you've done a good job. You've managed through this. You have no nonperforming problems. You've managed to come public at the absolutely right part of the cycle. Please keep doing what you're doing. When you can buy back some stock, please do so. And you'll have a very happy largish shareholder. [But] if you decide to use the money you've taken to buy your competitor or do something, and [you] put out some pabulum about long-term shareholder value, we're going to come in and unemploy you.'" Stilwell modified the verb to "unemploy" with a strong, Anglo-Saxon gerund.

Stilwell lays out the same set of expectations for both banks in his 13D filings: "We hope to work with existing management and the board to maximize shareholder value," the language says. "We will encourage management and the board to pay dividends to shareholders and repurchase shares of outstanding common stock with excess capital, and will support them if they do so. We oppose using excess capital to 'bulk up' on securities or to rapidly increase the loan portfolio. We will support only a gradual increase in the branch network. If the issuer pursues any action that dilutes tangible book value per share, we will aggressively seek board representation."

"This is one of those times when all of the stars line up," Stilwell winds up. "They've all lined up here. So, you know, frankly, a down market here would only help me at this point to make good investments in these because they come against the comps. This is the fourth year of a bear market in this sector. Will there be a fifth or sixth year? Maybe. But these are not on-edge institutions."

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## *Private island markdowns*

(December 2, 2011) Credit rolls in and rolls out like the fog, if you're from Kennebunkport, Maine. Or, it rolls in and rolls out like the tourists, if you happen to be from Miami. Either way, cycles in lending and borrowing constitute one of the main propulsion plants of the world's investment markets.

Real estate—illiquid, despised, discounted—is the subject at hand. It was subscriber Todd Tateo who observed last year that, for the precious right to convert an asset into cash at the twitch of a nerve, the world was prepared to pay exorbitantly. The price of liquidity has only gone up in the meantime.

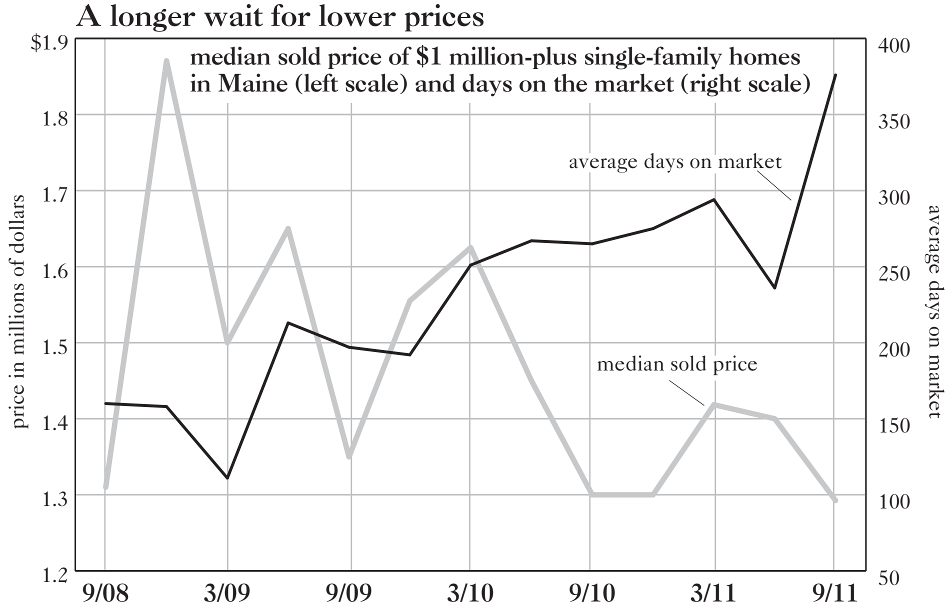
We turn, specifically, to the residential property markets at the north and south extremities of America's eastern seaboard. In preview, we are friendly toward high-end houses on the rocky Maine coast, a little less enamored of the luxury condominiums in greater downtown Miami. In the former, we see still-depressed value, in the latter, a vulnerable, China-derived, Brazilian-financed, exchange-rate-driven recovery.

In Wall Street argot, Maine would be considered a pink sheets market. Only about 1,000 houses change hands each month in the Pine Tree State, compared to approximately 20,000 per month in the Sunshine State. At the end of the third quarter, 7,800 Maine residences were trapped in the foreclosure pipeline, compared to 350,000 in Florida. Both markets are well off their boom-time highs, and both roll out the welcome mat for qualified buyers. But the reception awaiting the Portland shopper with, say, $3 million in check-writing capacity is likely to be especially ardent.

Scared of its own shadow, capital nowadays prefers cash to bonds, bonds to stocks and stocks to houses. Ever shrinking is the list of assets that the mainstream institutional investor deems "safe." And if German bunds have fallen out of consideration, as they seemed to do last week, it's a cinch that a 17-acre private island situated at the mouth of the St. George River along Old Hump Channel near Port Clyde, Maine—offered now at $800,000, including a "rustic" two-story structure, down from a 2008 asking price of $2.7 million—wouldn't pass muster, either. However, we think, there's something to be said for the island as well as for a roomy, 1992-vintage, not quite $2 million house in the coastal town of Harpswell, population 5,247. Hugely illiquid are these properties, yet each offers a hedge against the consequences of monetary "stimulus," as well as what Benjamin Graham described in another context as the "joy of possession."

"I am very concerned that safe-haven assets are fast becoming the riskiest assets with respect to long-term capital preservation and long-term returns," Chris Lynch, a former DLJ

**A longer wait for lower prices**




source: Maine Real Estate Information System bond executive turned owner of the largest high-end real estate brokerage firm in Maine, Legacy Properties Sotheby's International Realty, wrote to his friends and clients last month. "The pervading fear in the marketplace has created a new bubble which may burst like any other when signs of recovery or stability creep back into the financial system. We are thinking real estate shares qualities with bonds and gold, yet real estate is at the bottom of its price cycle while the others are at or near all-time highs."

Once upon a time, the sky seemed to be the limit Down East. MBNA, the big credit-card purveyor, moved a part of its operations to Camden, Maine, in 1997, and proceeded to teach the Yankees about the alternatives to thrift. Camdenites rubbed their eyes as the newcomers bought seven-figure houses, built their own yacht club to house their corporate watercraft (including the MBNA flagship, Affinity) and their own hangar at the Knox County airport in which to house their corporate aircraft. And to facilitate the comings and goings of the MBNA Lear jets and Gulfstreams, they presented the airport with $70,000 worth of landing lights.

MBNA, which in 2005 became a wholly owned subsidiary of Bank of America, literally rolled into Maine on a wave of credit. The wave crested in 2006-07—in 2006, BofA announced the closure of four Maine call centers—and house prices, in and out of Maine, have been falling ever since. High-end houses on the beautiful Maine coast never reached the valuation altitudes of comparable properties in Martha's Vineyard, Nantucket, Greenwich or Vail, but the bear market has not spared Maine on that account. By Lynch's estimate, houses in Maine's waterfront communities have fallen in quoted value by 15% to 20% from their highs, inland properties by as much as 25%.

With respect to top-end prices in Maine, the bottom may or may not be in; this publication is agnostic on the question. October brought a new lurch up in inventory and a step down in houses under contract for sale. Supply of houses priced at more than $1 million, expressed in months of average inventory totaled 141, the highest in at least the past two years (runner-up was

*"Sora," of Harpswell, Maine*

November 2010, when supply came in at 105 months). As for houses under contract, the grand total was four, one fewer than recorded in the cheerless month of April and the fewest in at least the past two years.

Granted, Maine's weather is a taste that some will never acquire, but the winters are cold in Vail, Colo., too, and there's no more to recommend Rehoboth Beach, Del., on a rainy afternoon in March than there is Cape Elizabeth, Maine. As for the storied beauty of the Pine Tree State, we are prepared to say that the artists and writers don't exaggerate. Then, too, there's value.

"For instance," reports colleague Charley Grant, "a six-bedroom, six-bathroom, 8,900-square-foot house in Cape Elizabeth, a 15-minute drive from downtown Portland. Built in 2005 and listed on realtor.com for 381 days, the property features a pool and spa, central air conditioning, a mother-in-law house and grounds that, in the Realtor's estimation, are 'lush' (a grand total of 1.65 acres). Asking price: $1,695,000. No waterfront access, but saltwater in Cape Elizabeth is a five-minute drive, tops. I went online to comparison shop and found that you can, indeed, do worse.

"To wit: A six-bedroom, six-bathroom, 8,800-square-foot house in Lewes, Del., i.e., Rehoboth Beach, without beachfront access, lists for $2.25 million. A six-bedroom, four-bathroom house with no waterfront access and just 2,766 square feet of living space in Edgartown, Mass., i.e., Martha's Vineyard, was listed—the ad vanished last week—for $3.45 million. A six-bedroom, six-and-a-half-bathroom house in Vail, with 8,300 square feet of living space, lists for $16.5 million. While Maine might never have the cachet of Martha's Vineyard or Vail, you'd infer from the price that the Cape Elizabeth offering was plopped down between a sewage treatment plant and an international airport."

You can value residential real estate in relation to similar structures in comparable markets as we have just done. Or, you can value it in comparison to its cost of construction or by what it might yield in rental income, which we are about to do. By all methods, the upper-end portion of the Maine market we judge to be relatively attractively valued. Of course, if the macroeconomy were to go from bad to worse, that relatively attractively valued, picturesque, $3 million Maine house might well trade at $2 million or less. Then, again, if the world truly goes to hell in a hand basket, you may wish you were living on your own 17-acre island on the St. George River. Stone Island, as that romantic sanctuary is known, lacking fresh water, a septic tank and, within the "rustic" living quarters, heat, is not for the faint of heart.

For those seeking truly to distance themselves from leveraged finance, Birch Island, in Greenville, Maine, is another option. You land at Bangor

Airport, drive 90 minutes to Moosehead Lake and hop on a boat. Thirty minutes later, you turn the key (a New Yorker always locks up) to your two-bedroom, one-bath summer cottage. A dock, boathouse, one-bedroom guest house, canoe and a pair of motorboats are included in the purchase price. You will have no company on Birch Island. Then, again, you have no electricity. Offered in August in *The Wall Street Journal* for $1.5 million, the property is currently listed at $650,000; it's been offered online for 526 days.

"What we have learned," Lynch advised his readers late last summer, "is that Maine is tied more closely to the global economic fabric than we may have believed. Today's prospective sellers need to reacquaint themselves with these new pricing levels as buyers have clearly made the adjustment."

In Harpswell, there's a 20-year-old house named "Sora." It and its private dock, barn and bunkhouse were recently listed for not quite $2 million, or $419 for each foot of its 4,713 square feet of living space. Lynch and his team reckon that the house would rent for $6,500 a week during the 12-week summer season (a total of $78,000) and for $2,500 a month during the nine-month off-season (i.e., $22,500), for a grand total of $100,500 before property taxes of $6,331 and maintenance costs of $10,000. At the listing price, Sora would yield 4.26% after tax and before the additional maintenance costs that somehow never fail to bite the homeowner in the ankle. Remote Harpswell has no school system—a plus in the tax department—but, then, it draws few visitors, a negative for rents.

"Or consider," our reporter goes on, "a five-bedroom, three-and-a half-bath waterfront house in Falmouth. Living space measures 3,926 square feet, with a truly spectacular kitchen; at the $2.2 million listing price, that's $560 per square foot. Right down the street is the Town Landing Market, which sells live lobsters for $4.99 a pound, a seemingly arbitragable difference with the $16.99-per-pound lobster sold at Eli's on East 91st Street between York and First Avenue in Manhattan. Built in 1925 and renovated in 2006, the house is set on grounds that 'are just as amazing as the home itself, boasting beautiful stone walls, perennial gardens, patios, in-ground pool and a gazebo overlooking the water and private boat dock,' according to the Realtor. This claim has been vetted by your correspondent and deemed to be accurate, perhaps even an understatement. Neighbors are few and far between, despite the central location. Projected rental income is $6,000 a week in season, $4,000 a month for the other nine months, for a total of $108,000. Property taxes come to $28,320, while annual maintenance (the owner swears to it) amounts to a mere $7,500. After taxes and before surprises, this property would fetch 3.3% a year at the asking price.

*Portland dowager—with a 6.1% yield*

"Perhaps the best value of the day," Grant winds up, "came from a four-bedroom, three-and-a-half-bath townhouse in downtown Portland, within an easy walk to both the city center and the waterfront. Built in 1890 and restored in 2007, the property is listed for $895,000, or $249 for each of its 3,589 habitable square feet. Estimated annual rental income of $70,200 compares with property taxes of $9,700 and—so they are represented—purely nominal maintenance fees; call them $6,000. On this basis, at the offered price the townhouse would yield 6.1%. Portland, let me add, is an extremely livable city. Driving throughout Cumberland County all day, including the morning and afternoon rush hours, we encountered no 'traffic,' as a New Yorker understands the meaning of that word. On Monday evening, the total elapsed time between arriving at Portland International Airport and checking into my downtown hotel was 40 minutes, including a stop at the rental car counter and some shoddy navigation. Portland is that urban rarity, a city both walkable and drivable."

Famously cosmopolitan Miami is flyable. Laid low by the real estate bust, the biggest city in the Sunshine State is host to a new wave of condominium-buying, South American immigrants. They come with cash, too. In Miami-Dade County, according to the Miami Association of Realtors, foreign buyers usually requiring no mortgage account for 60% of residential real estate sales. According to Peter Zalewski, principal of Condo Vultures LLC, a Bal Harbor, Fla., advisory firm, "When they're running their numbers," referring to the foreign apartment investors, "they're saying: 'We have a weak dollar. We have U.S. predictability, in terms of the legal system as well as title. And we have this safe haven that we can ultimately run to, if need be, if the economic and social conditions deteriorate in our home country. . . .' Basically, it's a recolonization of Miami."

You'll hear no protests from the greater downtown Miami real estate community (the area consists of 60 blocks bounded on the north by the Julia Tuttle Causeway, on the south by the Rickenbacker Causeway, on the west by I-95 and on the east by Biscayne Bay). Of the 350,000 Florida homes in foreclosure, 100,000 are situated in the three most populous south Florida counties—Palm Beach, Broward and Miami-Dade. Like the infamous local humidity, this immense overhead supply hangs heavy. "We see considerable downside for home prices in the metro areas of Miami and Tampa," says a Nov. 16 report from Bank of America Merrill Lynch. "There is a judicial foreclosure process in Florida, which means that it takes considerably longer to clear the foreclosure overhang. This has left a considerable number of homes in the foreclosure pipeline, which will depress prices. In addition, the regional economy is weak, with unemployment above the national average."

Borrowing liberally from the poet Emma Lazarus, the brokers and developers of greater downtown Miami may hopefully murmur, "Give me your Brazilians, your Venezuelans, your Argentines, your rich yearning to breathe free. . . ." The great American bear market is one side of the Miami real estate coin, colleague David Peligal observes. The view of that bear market from Sao Paulo is the other side. Those who gaze upon our sunken prices from South America or Mexico can hardly believe their eyes, says Harvey Hernandez, managing partner and chairman of Newgard Development Group, a Miami developer. "Their properties, wherever they're from . . . are worth double or three times as much as here in Miami," he says of the prospective buyers to the south. They say, 'This is impossible—it cannot be.' They see value."

Peligal, on a recent visit to Miami, also spied value, though not so much as to cause him to doubt his senses. The focus of his investigation was the Icon Brickell, a 1,793-unit, triple-tower, boom-time jewel in the southern section of greater downtown Miami. The project, which was unveiled at the peak in 2006 and completed at the bottom in 2008-09, bears no outward sign of the scars of the man who imagined it, developed it and subsequently lost it, Miami's own "condo king," Jorge Pérez, chairman of the Related Group. Peligal, echoing his tour guide, broker Felicia Doring of Fortune International Realty, pronounces the premises "unique," "ultra-contemporary" and "over the top." A series of immense sculpted faces, done in the style of the Easter Island monoliths at a cost of $15

*Icon Brickell: "over the top"*

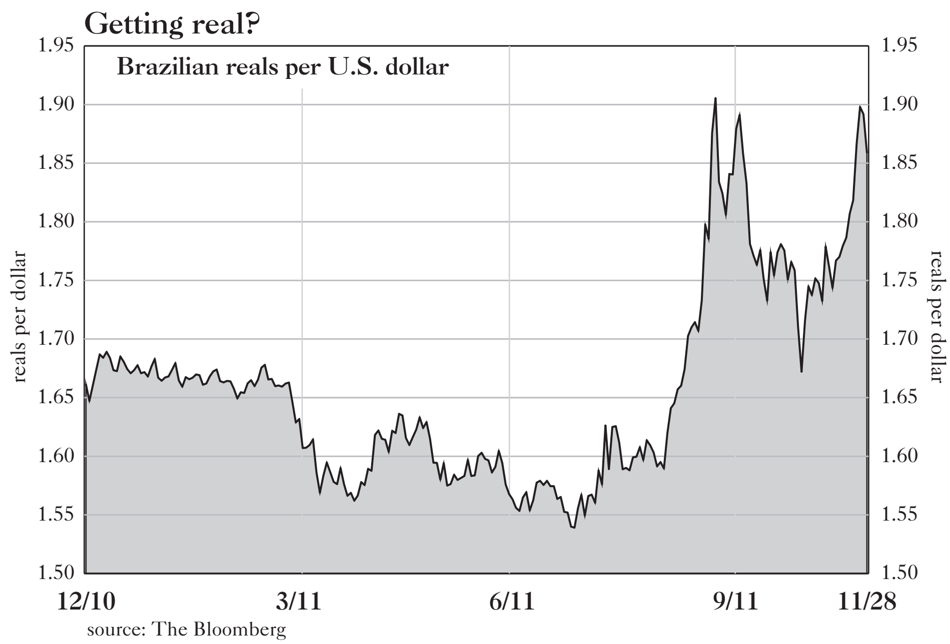
million, would seal the over-the-top claim all by themselves. Furthermore—a notable change from the dark days of 2009—the apartments are selling, and at prices well in excess of the $300 per-square-foot cost of construction.

Consider, says Peligal, a 1,500-square-foot, Biscayne Bay-facing, two-bedroom apartment on the eighth floor of the Icon Brickell's south tower. It's listed at $640,000, or $427 a square foot. "By way of preface," Peligal relates, "the rental market in south Florida has tightened as the 'strategic' defaulter, the person who bought at the peak of the market, opts for a short sale and decides to rent. Second, whereas the average high-end condo might rent for $2 per square foot per month, condos at the Icon Brickell rent for a premium because of the location, amenities and clientele associated with the building. You can get $2.47 per square foot per month, or $44,400 a year.

"Now, then," Peligal continues, "property taxes are roughly 2% of the $640,000 purchase price, or $12,800 a year, while condo maintenance fees are on the order of 56 cents per square foot per month, or $10,000 a year. Subtracting taxes and maintenance costs from rental income leaves us $21,600, which, when divided by the $640,000 listing price, delivers a rental yield of 3.38%. Not fantastic but better than the 10-year Treasury."

"Renters today are enduring high rents in anticipation of being able to own in the future," the afore-quoted Zalewski sums up the situation. "Foreign buyers are acquiring today in anticipation of being able to unload their product in the future to domestic buyers who are going to be able to tap into leverage."

If the global financial gales reach even little Harpswell, Maine, they rock Miami, the New York City of Latin America. To simplify only slightly, Brazilians can afford apartments in the Icon Brickell because the Brazilian real is strong. The real is strong because



commodity prices are high. Commodity prices are high because China was growing. If, as we believe, Chinese growth is braking, commodity prices would likely continue to fall and the real continue to weaken. Against the dollar in the past four months, the Brazilian unit has fallen by 16%. "Much of South America's prosperity over the past decade—and its sense of having arrived, including its significant contribution to global economic growth—has been due to the China-inspired commodity price boom," notes *Financial Times* columnist John-Paul Rathbone.

If the China-Brazil axis poses a distant and abstract threat to the recovery of Miami condo prices, the resumption of new residential construction on Brickell Avenue itself is a risk both local and immediate. An Oct. 17 press release from Harvey Hernandez's Newgard Development Group announces a notable milestone: "BrickellHouse, a 46-story luxury residential tower under development by Newgard Development Group, becomes the first newly conceived condominium project to launch since 2008, reflecting the rising demand for urban living in South Florida and fast-improving market dynamics in downtown Miami." A kind of budget Brickell project—"MyBrickell"—is also on tap, slated for completion by the end of 2013, with the prospective residents themselves expected to front most of the capital.

Taking one thing with another, subjective as well as objective—price, value, scenery, weather, proximity to the chain of causation running from China to the quoted value of a bushel of soybeans and to the real-dollar exchange rate—we'll opt for a house in Maine. Or a reasonably priced island. It could be just the place to wait out the coming rationalization of the world's monetary and banking arrangements.

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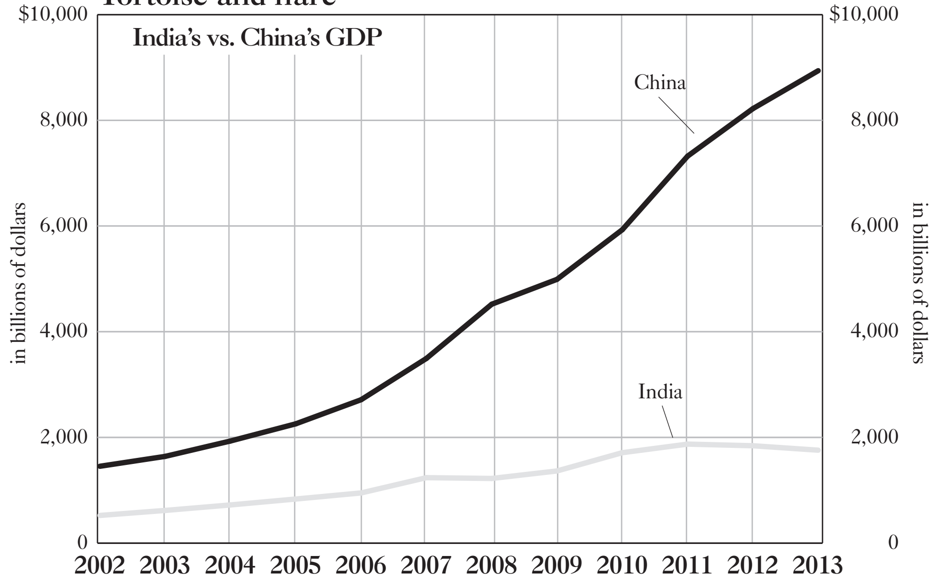
**Tortoise and hare**



source: International Monetary Fund

## *To India and back in just six days*

(March 21, 2014) If you, like your editor, had just returned from Mumbai, the hot and teeming port city formerly known as Bombay, you would know that the vast Indian electorate, 815 million strong, will be going to the polls starting on April 7 to elect a new prime minister; results are due on May 16 (it's a big country). You would further be aware that the front-runner in that marathon contest, Narendra Modi, a.k.a. NaMo, has vowed to put his vast, poor and comprehensively mismanaged country on the road to modernity.

Now under way is a financial travelogue whose terminus is optimism. *Grant's* is bullish on India; on the values currently available in India, we are lukewarm. By the numbers, the Indian market is hardly bubbly—market cap to GDP stands at a reasonable 63.7%. The trouble, currently, is that foreigners love the place. On form, they will sooner or later decide to hate it (as they did last summer). In their flight, they will surface value.

If, as we believe, China is yesterday's growth story, India might be tomorrow's. We so speculate in full knowledge that, for the past dozen years, Mumbai's market has run rings around Shanghai's, even as India's GDP growth has drastically lagged China's. For the investor as opposed to the statesman, macroeconomic growth places a distant third to price and value on the scale of financial virtues. What's new in India is the possibility of stronger growth and less toxic politics.

The oft-told Indian growth story would be a gift to the world if it finally did unfold—say, under a new leader who redirected the Indian bureaucracy away from its customary work of thwarting Indian enterprise. You know that crony capitalism has a foothold in a country when, as in India's case, the various contenders for and buyers of public office are expected to spend a combined $5 billion (so says India's Center for Media Studies). This stupendous outlay would represent 0.28% of GDP, about seven times more, in proportion to GDP, than the $7 billion American boosters spent on the 2012 U.S. elections.

The prospect of a business-friendly Modi government is the talk of financial Mumbai—except in the presence of an American, in which case the topic is steered as quickly as possible to Janet Yellen. Will she or won't she taper? If so, how quickly? This American tried to redirect the conversation. Say, he asks, could India be on the verge of something wonderful? Perhaps, some say. Megh Manseta, private investor, genial host and—*and*—paid-up subscriber, demurs. "I have often been enthusiastic about India's immediate prospects, and have often been wrong," he says. He adds that, because of the volatility that the foreign herd brings to India's not very deep markets, it's always advisable to hold lots of cash, "so you can buy cheap."

Better if a financial traveler had landed at the Chhatrapati Shivaji International Airport during the August taper tantrum. Indian markets reeled then rallied. From the summertime lows, the rupee has leapt by 12.4% (measured against the U.S. dollar), the Sensex index of 30 stocks by 21.9%. On March 6, foreign institutional investors ("FIIs" in this land of acronyms) poured $212 million into Indian stocks, the biggest single-day inflow of the year. The Sensex scored an all-time high, which level placed it at 14 times the consensus 2015 earnings estimate vs. a MSCI Emerging Markets price-earnings ratio of 10.3 times.

On Monday evening after the Friday in which the indices made their early-March records, a friendly group of fund managers finished a Mumbai dinner party with an impromptu exchange of investment ideas. Two of this company picked stocks that had jumped by 20% or more on that very day. It was enough to make the hair stand up on the back of a contrarian's neck. Then, again, it is possible to lose the long-term scent. In the early 1950s, with the Dow still poised below its 1929 highs, a bullish American investor pronounced that "the market looks high, and it is high, but it's not as high as it looks." The Dow climbed much higher. Perhaps the Sensex today, although it looks high and is high, is not so high as it looks.

Indian investors—at least the ones encountered in this flying visit—revere Benjamin Graham, the father of value investing, but their functional muse is Phil Fisher, the guru of growth investing. More than deep value, growth is the Indian investment mantra. Successful Indian investors talk up the likes of Blue Dart Express, a micro-cap courier service and integrated package-delivery company that, according to J.P. Morgan, is generating sales growth of roughly 30% per annum and is quoted just under 40 times' trailing net income. The bulls' frame of reference is wealth conferred on such visionaries as those who brought Infosys public in 1993. The buy-and-hold return to date on that especially satisfactory investment is 267,944%—before tax, if applicable.

As the law stands today, capital gains are tax-free after a year's holding period. Dividend income is taxed at the corporate source and is free of tax to the recipient. Indian individuals seem unmoved by these blandishments. Indian fund managers report that the public is out of the market. You can set your watch by their ill-timed comings and goings, one of these fiduciaries relates. Expect them back when the Sensex P/E multiple tops the 20 marker. They buy at the highs.

If so, the Indian public is much like other publics. Its youth is what sets the Indian public apart. By 2015, according to United Nations' projections, the median age of India's population will stand at 26.9 years. China's will be 36 years and Western Europe's 43.7 years. Here is what the Indian optimists call their nation's "demographic dividend." In many more ways than one, India is a growth story.

Not that the chance to buy low is permanently foreclosed to the value-seeking investor. India busts as well as booms, as Manseta notes, and it's especially prone to turmoil during election season. In 2004, when the Congress party confounded the experts by ascending to power, the stock market collapsed (*Grant's* was bullish after the break: see "Up with India," May 21, 2004). In 2009, Congress won in a landslide and the stock market—surprised again—rallied by 17% in a day.

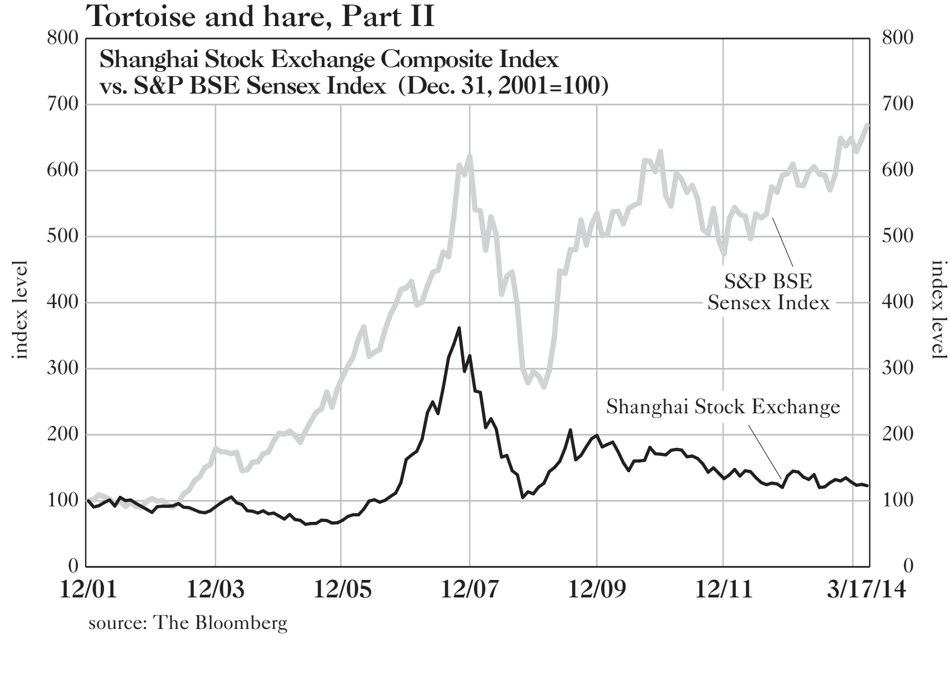
There was a little bust only last week in the market in inflation-linked Indian debt. In June 2013, the Reserve Bank of India issued 65 billion rupees worth of 10-year, rupee-denominated, inflation-indexed notes—at today's exchange rate of 61.21 rupees to the dollar, $1,062 million worth of debt. The coupon was 1.44%; the Wholesale Price Index was the indexation benchmark. The issue traded at around par until the RBI announced its intention to shift its policy-making focus away from wholesale prices to consumer prices. The WPI linkers promptly plunged to 80, at which level they commanded a yield four percentage points higher than the measured rate of wholesale price inflation.

Four percentage points of real yield—who could resist? According to "*Mint*," the financial supplement to the *Hindustan Times*, investors resisted in droves. "Bond traders don't trade on this bond any more," the paper reported last week, "but there are some infrequent trades, mainly by [mutual] fund houses trying to accumulate it [individuals may buy Indian TIPs only through mutual funds]. Banks want to get out of WPI bonds, given the steady drop in prices. In the future, as everything gets measured in terms of consumer price-based inflation, this bond would likely become a dud and banks may not find buyers, they fear."

No smile of cultural superiority will cross the face of any reader who recalls how few Western investors rushed to buy America's leveraged loans, junk bonds, structured mortgage securities and other such (money-good, for the most part) assets at knockdown prices in the wake of the 2008-09 credit crisis. Greed and fear are human universals, like religion or the hamburger.

The average Indian has no bank account, let alone a brokerage account, but he or she knows enough about government-issue money to buy gold. It confounds the scholars at the Reserve Bank that the unlettered peasantry prefers shiny metal (despite stiff new import taxes levied on bullion) to compound interest. Since Raghuram Rajan

**Tortoise and hare, Part II**




source: The Bloomberg

was named governor in September, the Reserve Bank has raised its policy interest rate three times, most recently by 25 basis points to 8%. The CPI for February came in at 8.1%, the WPI for February at 4.68%, the latter being the lowest reading in nine months.

Striking recent improvements in inflation on the one hand, and in the current account deficit on the other, are prompting hopes of a virtuous circle of lower inflation and lower interest rates. It will take a circle of saintly virtue to wean the Indian public off gold, we conjecture. The rupee was quoted at seven to the dollar in the lifetime of middle-aged Indian savers; now, on a rally, it's quoted at 61 and change. Then, too, according to an analysis of investment returns over the past two decades as compiled in *The Hindu Business Line* of Feb. 9, gold in rupee terms generated an annual return of 12.6%. Lagging was the Sensex, at 11.4% per annum (a performance that was flattered by survivor and selection bias, as the paper noted); the Industrial Workers' Consumer Price Index was up by 7.9% a year.

"The current bull run," writes Rajesh Mascarenhas in the March 11 *Economic Times*, "will go down in history as one of the strangest ever. For one, the Nifty's rapid 27% climb [i.e., that of the CNX Nifty, a.k.a., the Nifty 50] from 2013 lows has not been accompanied by any major IPOs or public issues. Cash-strapped, debt-laden companies, usually among the first to jump at an opportunity to sell their overvalued shares in a bull market, are reluctant this time around. . . . Secondly, the economy continues to be in a deep funk. The current account situation may have improved, but industrial productivity is in the dumps and corporate investment is showing no signs of taking off. The previous bull runs were accompanied by strong earnings and decent economic fundamentals."

The bullish visitor ponders two distinct risks in Indian equities. The first is buying now at mediocre prices. The second is holding back too long from what could prove to be among the most significant economic events in a lifetime. Let us say that you, gentle reader, were not on board in America for the Reagan revolution, that you missed the post-World War II German miracle and the Thatcher era in London. India—so we speculate—could represent another chance to participate in investment history. Here, though, we side with our friend Manseta: Buying low is the thing, always and everywhere. Bullish politics may afford almost as many moments of investment opportunism as bearish politics.

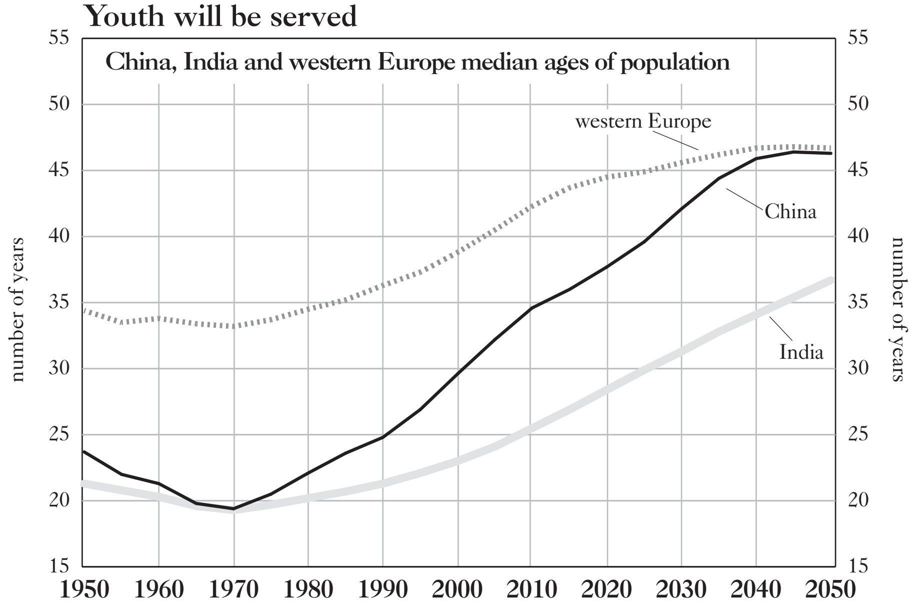
What do we know about the great white hope of Indian economic liberalization? Narendra Damodar Das Modi is a nationalist, a member of no Indian political dynasty (therefore, legitimately, an "outsider") and a Hindu. He is punctual. He is said to be incorruptible. Sixty-three years old, his face is framed with white hair and a neat white beard. He inspires strong feelings among fans and detractors alike. On the one hand, an Indian driver surprised his passenger last week with the ring-tone that issued from his cell phone; it was Modi's voice. On the other, the vice president of the incumbent Congress party, Rahul Gandhi, turned up in the newspapers comparing the challenger to Hitler.

Modi, the candidate of the Bharatiya Janata Party (BJP), has helped to deliver light, power and growth to the state of Gujarat, which he has governed since 2001. India's sizable Muslim population reviles him for his alleged complicity in a 2002 riot that led to the death of a thousand or more people, most of them Muslims. Modi denies the charges, and no court has found him guilty of a crime in connection with the killings.

If Modi gains power, how would he—as the press is wont to ask the question—"Modi-fy" India? He has pledged a new shake for enterprise and an end to the kind of corruption that freezes business decision making. Gurcharan Das, an eloquent voice for free markets in India—he is the author of the wonderful 2002 book, "India Unbound"—tells this publication by e-mail, that Modi, if elected, would improve the administration of the Indian state: "He would un-gum the system. He would give the bureaucracy a sense of purpose and improve the implementation of the laws—which is no small feat, indeed. This is what he did in Gujarat." What he gives no sign of intending to do is rolling back the suffocating Indian state.

The world's most populous democracy is among the world's least functional nations. The World Bank reports that 21.9% of the Indian population lives below even the Indian poverty line, that 17.5% of the Indian people are undernourished and that more than 35% are illiterate. Inside a five-star hotel, say the opulent Taj Mahal overlooking Mumbai harbor, a tourist may feel as if the World Bank had exaggerated. He or she is likely to reconsider upon venturing even a few yards beyond the ferocious-looking Sikhs who stand guard at the hotel gate. Whizzing cars and motorbikes narrowly miss the pedestrians who amble down the middle of the street. Horns blare, stray dogs wander, beggars accost. Rama Bijapurkar's new book, "A

**Youth will be served**




source: United Nations

Never-Before World," reports that in the six years till 2013, Mumbai added 51% more cars but next to no new roads. A visitor could have guessed it.

Under British colonial rule in the first half of the 20th century, India grew by an average of just 1% a year, according to Das in "India Unbound." Growth accelerated to an average of 3.5% a year between 1950 and 1980. "[B]ut so did population growth (to 2.2%); hence the net effect on income was 1.3% per capita (3.5 minus 2.2)—this is what we mournfully referred to as 'the Hindu rate of growth.'"

The British packed up and sailed away in 1947, leaving their socialism behind. High taxes and oppressive regulation were the watchwords of successive post-colonial governments. J.R.D. Tata (1904-93), one of the great Indian industrialists, was in a perpetual, losing struggle with the Indian state. In 1953, his pride and joy, Air India, was nationalized. And when, 15 years later, the government of Indira Gandhi accused him of wielding unchecked power as a corporate monopolist, Tata just shook his head. "No, dear boy," Das quotes Tata as addressing a friendly politician in the late 1960s, "I am powerless. I cannot decide how much to borrow, what shares to issue, at what price, what wages or bonus to pay and what dividend to give. I even need the government's permission for the salary I pay to a senior executive." By this time, Tata was paying a wealth tax on top of a 97% income tax. He sold assets to make ends meet.

A partial dismantling of the worst of the government controls in the 1980s ushered in a period of stronger growth: 5.6% on average for the decade. Greater liberalization in the 1990s delivered 10-year average growth of 6.3% (with population growth having subsided to 1.9% a year, real per capita income rose by 4.4% a year). With the government out of the business of licensing every proposed corporate strategic decision, foreign investment rose 30-fold, Das records. To counteract the rise of foreign banks, the Reserve Bank of India, in 1993, began to award private banking licenses, including one to what has become HDFC Bank, now the No. 7 bank in India by asset size; ICICI Bank, the No. 2 bank by asset size and the largest of the investor-owned institutions, came into the world in 1994.

Far and away the largest Indian bank is one that Indira Gandhi nationalized, the sprawling, accident-prone State Bank of India, now majority-owned by the government with a 41.4% stub in the hands of the public. State Bank, with assets of $376.8 billion, 224,000 employees (most of them union members) and 15,297 branches and outlets (more than twice the number operated by America's most far-flung institution, Wells Fargo & Co.), accounts for roughly a quarter of India's bank loans. In the bad old days, politicians were the nationalized banks' de facto loan officers. Things have improved, though the public-sector institutions—controlling three-quarters of indigenously held Indian banking assets—have contributed more than their share to the industry's growing asset-quality problem. "Stressed" assets, which today constitute 11% of the total loans of Indian banks, will reach 14% next year, according to projections quoted in the "*Mint*" supplement in the March 10 *Hindustan Times*.

Though India's financial system is opening up to the outside world, it's still a ways from Wall Street. For one thing, Carl Icahn can stay home; there's no functional market in corporate control because most Indian public companies are majority-owned by their founding families. "They resist any restructuring that is dilutive to equity shareholders," a knowledgeable observer relates. Then, too, a visiting American will observe the absence of a market in distressed assets. "State-owned banks own 90% of corporate term loans," our source says. "They are corruptible and not very competent at recovering loans." The head of the workout department of the State Bank was recently quoted as comparing the work of recovering bad debts to that of putting toothpaste back in the tube. Of course, toothpaste really doesn't go back in the tube.

The macroeconomic back story to the rise in NPAs is the deceleration in measured Indian GDP growth. In a snapback from a subpar 2008-09 (the fiscal year ends March 31), real growth vaulted to 9.3% in the 12 months ended March 31, 2011. Growth in the just-ending fiscal year is expected to register only half that much. Real growth on the order of 4½% to 5% would be America's dream come true. For India, it is worrisomely slow. That the stock market has been climbing in the face of such weak macroeconomic data presents Indian analysts with the age-old conundrum, namely: What (if anything) does the market know? A man with four full days on the ground in Mumbai has decided that the market knows that faster growth and stronger corporate earnings are in store no matter who wins the election. He judges that the market is correct in this divination.

You must understand, says an executive of a fast-growing Mumbai financial services company, that India is not one country but a union of 28 linguistically distinct states (there will soon be 29). Hindi is the most widely spoken language, but there are dozens of others. At the time of the 2001 census, not quite 1.2% of the population spoke Maithili, but that not-quite 1.2% represented 12.2 million people. India is a gigantic country.

China's GDP crossed the $1 trillion line in 1998; India's in the same year measured $429 billion. Now China stands at the threshold of $10 trillion, India at almost $2 trillion. For our part, we are prepared to accept that India has grown more slowly than China and that the Indian economy is smaller than China's. As to the details?

The International Monetary Fund "Consultation" report, released in February, makes a revealing confession. "There are longstanding deficiencies in employment data," the document acknowledges: "They are only available on an annual basis and with a substantial lag, and they only cover the formal sector, which accounts for a small segment of the labor market." The aforementioned "A Never Before World" relates that, as of 2009-10, "only 40% of urban working people and less than 10% [of] rural working people in India had a regular income. In urban India, 41% were self-employed and about 20% were casual labor (daily wage earners, usually). In rural India about 55% were self-employed, and close to 40% were casual labor."

Or—in the glass half-full vein—one might call them entrepreneurs. Indians have survived socialism, Gandhi-ism, Nehru-ism, confiscation and corruption. What remains to be seen is whether they can survive better government, if such lies in store. We're hopeful, jet-lagged—and bullish.

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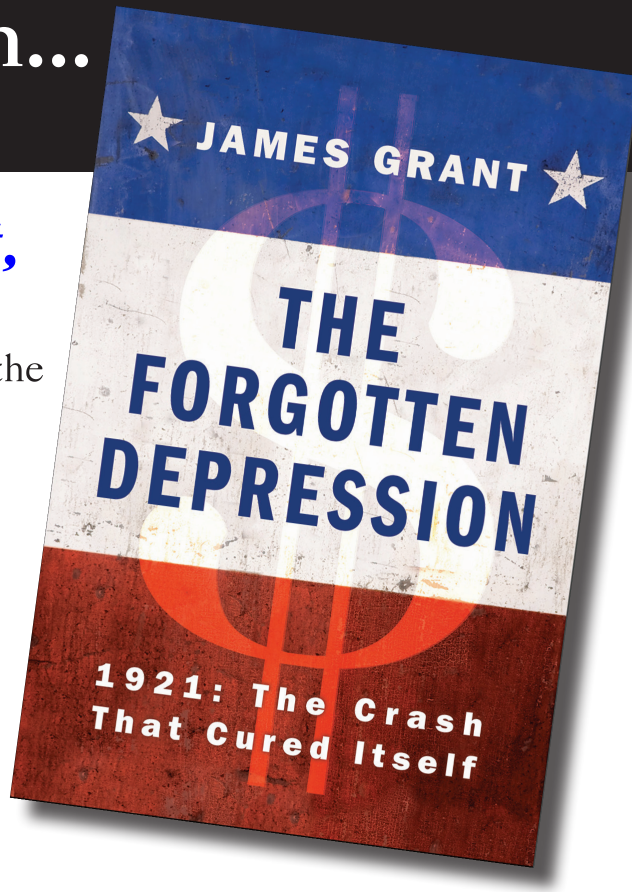


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